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December 1, 2004

VIA HAND DELIVERY
The Honorable George Dorn
Interim Executive Director
The Public Service Commission of South Carolina
100 Executive Center, Suite 100
Synergy Complex, Saluda Building
Columbia, South Carolina 29211

Re: Docket No. 2004-178-E
Application of South Carolina Electric & Gas Company
for an Increase in Electric Rates and Charges
Our File No. 4381.203

Dear Mr. Dorn:

On behalf of South Carolina Electric and Gas Company, please find enclosed for filing, an original and ten (10) copies of the *Post Hearing Brief of South Carolina Electric & Gas Company in the Form of a Proposed Order,* in the above-referenced matter. A *Certificate of Service* is attached reflecting service on all parties of record. This Post Hearing Brief, with Appendices, is being filed on behalf of SCE&G, the Commission Staff and the South Carolina Energy Users Committee.

Please be kind enough to date-stamp and return the extra copies of each of these document via the bearer of this letter.

Thank you for your assistance.

Respectfully Submitted,

/s/

Francis P. Mood

FPM/am

enclosures

cc: All Parties of Record

BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA
DOCKET NO. 2004-178-E
December _____, 2004

IN RE:	Application of South Carolina Electric & Gas Company for Adjustments in the Company's Electric Rate Schedules and Tariffs	)))))

POST HEARING BRIEF OF SOUTH CAROLINA ELECTRIC & GAS COMPANY IN THE FORM OF A PROPOSED ORDER

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BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA
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IN RE:	Application of South Carolina Electric & Gas Company for Adjustments in the Company's Electric Rate Schedules and Tariffs	)))))	POST HEARING BRIEF OF SOUTH CAROLINA ELECTRIC & GAS COMPANY IN THE FORM OF A PROPOSED ORDER

PREFACE

South Carolina Electric & Gas Company ("SCE&G," "Company"), the Applicant in the above-captioned proceeding, hereby submits the following Post-Hearing Brief to the Public Service Commission of South Carolina (the "Commission," "PSC"). This brief is submitted in the form of a proposed order. The Proposed Order is concurred in by the Commission Staff and the South Carolina Energy Users Committee. Each party to this Proposed Order has attached an Appendix for consideration by the Commission in the event that the Commission does not approve the Stipulation and Settlement recommended in this Order.

I.

INTRODUCTION

This matter is before the Commission on the Application of the Company filed July 1, 2004, for adjustments in the Company's electric rates and tariffs, and for certain changes in the Company's General Terms and Conditions for service. Hearing Exhibits 22 (Application) and 20 (Revision to Application). The Application was filed pursuant to

S.C. Code Ann. §§ 58-27-820, 870 (1976, as amended) and *S.C. Code Regs.* 103-834 (as amended) (South Carolina Public Service Commission Rules of Practice and Procedure).

The Company's presently authorized rates and tariffs were approved by the Commission in Order No. 2003-38, issued January 31, 2003, in Docket No. 2002-223-E. According to the Company's calculations, the rates and tariffs as requested in the Company's Application in the present docket would produce an increase in annual revenues of approximately $81.1 million and provide a return on common equity of 11.75%,.

By letter, the Commission's Executive Director instructed the Company to cause to be published a Notice of Filing and Hearing in a newspaper of general circulation in the areas affected by the Company's Application. The Notice of Filing and Hearing indicated the nature of the Company's Application and advised all interested parties desiring participation in the scheduled proceeding of the manner and time in which to file appropriate pleadings. The Company was also required to directly notify all customers affected by the proposed rates and tariffs. The Company furnished affidavits demonstrating that the Notice was duly published in accordance with the Executive Director's instructions and certified that a copy of the Notice was mailed to each affected customer.

Petitions to Intervene were received from the Consumer Advocate for the State of South Carolina ("Consumer Advocate"), the United States Department of the Navy ("Navy"), S.M.I. Steel-South Carolina ("SMI"), South Carolina Energy Users Committee ("SCEUC"), Wal-Mart Stores, Inc. ("Wal-Mart"), Columbia Energy, LLC ("Columbia Energy"), and Frank Knapp ("Knapp").

The Commission Staff made on-site investigations of the Company's facilities, audited the Company's books and records, and gathered other detailed information concerning the Company's electric operations. The Consumer Advocate, Navy, Columbia Energy, and SCEUC likewise conducted extensive discovery.

A public hearing was held in the offices of the Commission from November 1 through November 5, 2004. The Honorable Randy Mitchell, Chairman, presided. SCE&G was represented by Catherine D. Taylor, Esquire, Belton T. Zeigler, Esquire, Mitchell M. Willoughby, Esquire, and Francis P. Mood, Esquire. The Consumer Advocate was represented by Hana Pokorna-Williamson, Esquire, and Elliott F. Elam, Jr., Esquire. The Navy was represented by Audrey J. VanDyke, Esquire, and Marilyn Johnson, Esquire. SCEUC was represented by Scott Elliott, Esquire. Frank R. Ellerbe, III, Esquire, represented Columbia Energy. Mr. Knapp appeared *pro se*. SMI and Wal-Mart did not participate in these proceedings. The Commission Staff was represented by F. David Butler, Esquire, General Counsel.

The Company presented the direct and rebuttal testimony of Neville O. Lorick, its President and Chief Operating Officer; Kevin Marsh, its Senior Vice President and Chief Financial Officer; Carlette L. Walker, Assistant Controller of SCANA Corporation's Regulated Subsidiaries, including SCE&G; Thomas R. Osborne, Managing Director Global Energy and Power Group, Investment Banking Department, UBS Warburg, LLC; and Burton G. Malkiel, Ph.D., Chemical Bank Chairman's Professor of Economics at Princeton University. The Company presented direct testimony only of William B. Timmerman, its Chairman and Chief Executive Officer; Julie M. Cannell, President of J. M. Cannell, Inc.; Jimmy E. Addison, its Vice President of Finance; John J. Spanos, Vice

President, Valuation and Rate Division, Gannett Fleming, Inc.; and John R. Hendrix, Manager of Electric Pricing and Rate Administration, SCANA Services, Inc. The Company presented rebuttal testimony only of Joseph M. Lynch, its Manager of Resource Planning, and Julius A. Wright, Ph.D., President of J. A. Wright & Associates, Inc.

The Consumer Advocate presented the direct and surrebuttal testimony of Glenn A. Watkins, Vice President and Senior Economist of Technical Associates, Inc. SCEUC presented the direct testimony of Kevin O'Donnell, President of Nova Energy Consultants, Inc. The Navy presented the direct testimony of Ralph C. Smith, Senior Regulatory Consultant with Larkin & Associates, PLLC. Columbia Energy presented the direct and surrebuttal testimony of David E. Dismukes, Ph.D., Consulting Economist with Acadian Consulting Group. The Commission Staff presented the direct and supplemental testimony of Sharon G. Scott, PSC Auditor; A. R. Watts, Chief of Electric, PSC Utilities Department; and the direct testimony only of Eddie Coates, Rate Analyst, PSC Utilities Department; and Labros E. Pilalis, MPA, JD, Research Analyst, Rhoads & Sinon Group, LLC. Mr. Knapp presented no witnesses.

There were no public witnesses; however, over the objections of the Applicant, the Commission read into the record letters from the Honorable John C. Land, III, Senator, Senate District 36, and the Honorable Harry Ott, Jr., Representative, House District 93 [Transcript of Record (TR) Vol. 1 at 58 – 71].

II.

FINDINGS OF FACT

Based upon the Application, the testimony, and exhibits received into evidence at the hearing and the entire record of these proceedings, the Commission makes the following findings of fact:

1. SCE&G is an electric utility operating in 24 counties in the central and southern areas of South Carolina, where it is engaged in the generation, transmission, distribution and sale of electricity to the public for compensation. (Hearing Exhibit 22). SCE&G's retail electric operations in South Carolina are subject to the jurisdiction of the Commission pursuant to *S.C. Code Ann.* § 58-27-10, *et seq.* (1976, as amended). SCE&G's wholesale electric operations are subject to the jurisdiction of the Federal Energy Regulatory Commission (FERC). In addition to its electric operations, SCE&G also provides natural gas services, subject to the jurisdiction of the Commission pursuant to *S.C. Code Ann.* § 58-5-10, *et seq.* (1976, as amended).

2. The appropriate test year period for the purposes of this proceeding is the twelve-month period ending March 31, 2004.

3. The current rates, now in effect, exclusive of changes in the fuel component, were approved by the Commission in Order No. 2003-38, dated January 31, 2003, in Docket No. 2002-223-E.

4. At the outset of the hearing, the Company presented a Stipulation and Settlement between the Company and the Staff, concurred in by SCEUC, SMI, and Wal-Mart. For the reasons discussed hereafter, the Commission finds the terms of the Stipulation and Settlement reasonable and appropriate and hereby adopts and approves same.

5. The Company's Application sought an increase in annual revenues of $81,192,000 million. The Stipulation and Settlement adjusts the increase in annual revenues to $51,149,000.

6. In ruling on a motion of the Applicant, the Commission finds portions of the testimony of Dr. Dismukes to be admissible, nevertheless as set forth hereinafter, the challenged testimony addresses matters already determined by the Commission in Order No. 2002-19 (Docket No. 2001-420-E) and Order No. 2003-38 (Docket No. 2002-223-E).

7. It is appropriate to allow the Company to implement new depreciation rates as set forth below.

8. It is appropriate to allow the Company to recover its investment in the GridSouth RTO project, by including $7,047,982 in rate base, representing the average balance of the investment, and allowing amortization of $2,718,000 per year over five years.

9. It is appropriate to allow the Company to recover its cost of officer salaries and incentives, with the provision that, pursuant to the Stipulation and Settlement that amount be reduced $4,168,000.

10. The Company's investment in the Jasper Plant, $506,039,714, should be included in rates along with the Company's expenses of operating and maintaining the plant, and depreciation and property taxes related to it.

11. The fixed pipeline capacity charges related to natural gas service to the Jasper Plant, in an annual amount of $15,292,800 should be included in base rates with an off-setting credit to the Company's fuel clause calculation, to be determined.

12. It is not reasonable or necessary to order the Company to prepare a lead-lag study to present to the Commission at its next retail electric rate case.

13. It is appropriate that the revenues and expense related to the Company's wholesale power contracts with the North Carolina Electric Membership Corporation be accounted for as proposed by the Company without segregation of revenues, expenses or investment into separate classes of service.

14. It is appropriate that the Company's unrecovered fuel component of purchase power should be amortized over 3 years.

15. The Company should be allowed to levelize its turbine maintenance costs and amortize those amounts over eight years with appropriate reporting and oversight and with interest cost applied to any net overcollections.

16. It is appropriate for the Company to annualize the level of test year health care costs to reflect its most recent experience.

17. It is appropriate to allow the Company to adjust its Long-term Disability Expense to book liabilities associates with long-term disability payments to employees.

18. The Company should be allowed to adjust Plant in Service and O&M expense to comply with new NERC standards.

19. It is appropriate to allow the Company to recomputed its coal inventory to more accurately reflect the levels which are reasonably anticipated to exist while the rates allowed under this Order are in effect.

20. The Company should be allowed to recover its actual expense for property insurance during the test period.

21. The Company's proposal to defray the cost of the Saluda Dam Remediation project using certain synthetic fuel tax credits and the other tax benefits of the project is just and reasonable and should be approved.

22. A rule-making proceeding concerning the issuance of Requests for Proposals for purchased power before granting certificates of need to construct new generating facilities is not required.

23. Each of the pro forma adjustments to test year revenue, expense or investment, as set forth below is just and reasonable and supported by the substantial evidence on the record in this proceeding.

24. The Company's reasonable and appropriate federal and state income tax expense should be based on the use of a 35% Federal tax rate and a 5.0% South Carolina tax rate, respectively.

25. The appropriate operating revenues for the Company's retail operations for the test year under present rates and after accounting and *pro forma* adjustments are $1,478,656,000[1] ($1,478,654,000).

26. The appropriate operating revenues for SCE&G's retail operations under the approved rates are $1,529,805,000 ($1,559,846,000), which reflect a net authorized increase in operating revenues of $51,149,000 ($81,192,000).

27. The appropriate operating expenses for the Company's retail operations for the test year under its present rates and after accounting and *pro forma* adjustments per the Stipulation and Settlement are $1,204,077,000 ($1,203,829,000).

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[1] The amounts provided are those as filed by the Company and modified by the Stipulation and Settlement. The amounts from the Company's Application are provided parenthetically.

28. The appropriate operating expenses for the Company's retail operations under the approved rates are $1,217,082,000 ($1,228,391,000).

29. The Company's appropriate level of net operating income for return and after accounting and *pro forma* adjustments is $278,258,000 ($277,800,000) for SCE&G's retail operations, including customer growth of $3,679,000 ($2,975,000).

30. The appropriate net operating income for return under the rates approved and after all accounting and *pro forma* adjustments is $316,914,000 ($335,041,000) for retail operations, including customer growth of $4,191,000 ($3,586,000).

31. A year-end original cost rate base of $3,626,305,000 ($3,649,689,000) for retail operations consisting of the components set forth in Table B of this Order shall be adopted.

32. The capital structure utilized by the Commission in this proceeding for the determination of the fair overall rate of return is the capital structure of SCE&G, updated to August 31, 2004. This consists of 46.96% long-term debt, 2.73% preferred stock and 50.31% common equity. (…capital structure of South Carolina Electric & Gas, as adjusted to reflect additional equity from Stock Plans through September 30, 2004. This consists of 46.53% long-term debt, 2.71% preferred stock and 50.76% common equity.)

33. The embedded cost rate for long-term debt of 6.56% and its embedded cost rate for preferred stock of 6.40% as of August 31, 2004, have been used in the determination of the fair overall rate of return approved herein. This calculation should not, and therefore does not, include short term debt. (…long-term debt of 6.56% and its embedded cost rate for preferred stock of 6.40% as adjusted to reflect additional equity from Stock Plans through September 30, 2004.)

34. The fair rate of return on common equity which SCE&G should be allowed the reasonable opportunity to earn is within a range of 10.4% (10.50%) to 11.4% (12.45%). For the purpose of setting rates, the Company should use the mid-point of this range, 10.9% (11.75%), which is the rate of return adopted by the Commission for this proceeding. The capital structure and cost of capital which the Commission has approved herein produce an overall rate of return of 8.74% (9.18%) for SCE&G retail electric operations as depicted in the following table:

TABLE A

As of August 31, 2004:

COMPONENT OF CAPITAL STRUCTURE	RATIO %	EMBEDDED COST/RATE %	OVERALL COST/RATE %
Long Term Debt	46.96	6.56	3.08
Preferred Stock	2.73	6.40	0.17
Common Equity	50.31	10.90	5.49
	100.00		8.74

As Adjusted through September 30, 2004:

COMPONENT OF CAPITAL STRUCTURE	RATIO %	EMBEDDED COST/RATE %	OVERALL COST/RATE %
Long Term Debt	46.53	6.56	3.05
Preferred Stock	2.71	6.40	0.17
Common Equity	50.76	11.75	5.96
	100.00		9.18

35. The rate designs and rate schedules approved by the Commission and the modifications thereto as described herein are appropriate and should be adopted.

36. The proposed changes in the Company's General Terms and Conditions for service, as modified by the Stipulation and Settlement, are reasonable and amply supported by the evidence, as discussed hereinafter, and should be adopted.

37. By its Order No. 1999-655 in Docket No. 1999-389-E, the Commission has allowed the Company to accelerate depreciation of its Cope Generating Station, at its discretion, when revenue or expense levels warrant. This mechanism will expire on December 31, 2005, unless extended by the Commission. The Company has requested such an extension until December 31, 2010. The Commission finds that the justifications for its decision in Order No. 1999-655 are still reasonable and prudent and such extension should be allowed.

III.

RULINGS ON MOTIONS
(FINDING OF FACT NO. 6)

A. THE APPLICANT'S MOTION TO STRIKE TESTIMONY

By written motion dated, served and filed October 14, 2004, the Company moved to strike portions of the prefiled testimony of Columbia Energy witness Dr. David G. Dismukes.[2]

[2]The testimony in question was prefiled at Page 2, lines 18-23; Page 3, lines 1-3; Page 4, line 7 – Page 7, lines 11, 14-20 through "useful and. . . ."; Page 8, lines 4 – 12; Page 10, lines 3-20; Page 12, line 4- Page 35, line 23; Page 42, line 22 – Page 45, line 17; Page 47, line 6 – Page 48, line 2; Page 56, line 12 – Page 57, line 2.

The basis for the motion was that the testimony in issue was a re-argument of matters already adjudicated by the Commission in its Order No. 2002-19 (Docket No. 2001-420-E) and Order No. 2003-38 (Docket No. 2002-223-E). Consequently, the Company contended the testimony was an attempt to collaterally attack matters already decided by the Commission.

After deliberation, the Commission decided to hear the disputed testimony and rule on it in this Order. (TR Vol. 1 at 32).

ANALYSIS

The portions of Dr. Dismukes' testimony in issue raise challenges to the following aspects of the Jasper project:

1. The need for the facility.
2. The size of the facility (including economies of scale realized through construction of a larger facility, supported by the benefit of contracts with the North Carolina Electric Membership Corporation ("NCEMC").
3. The used and useful nature of the facility.
4. The prudence of the facility.

The Applicant contends that each of these issues has been previously addressed and adjudicated in the Company's siting docket (Docket No. 2001-420-E) in Order No. 2002-19 and in the Company's last rate case (Docket No. 2002-223-E) in Order No. 2003-38. In the Company's last rate case (Docket No. 2002-223-E), the Commission allowed in rates 58% of the Jasper Project costs (*i.e.*, those incurred through December 2002). The Company has asserted that the only relevant inquiries which could be made in the present proceedings would be:

1. Whether the Jasper project was completed as applied for and approved in the siting docket;

2. Whether the balance of the construction costs were reasonably incurred as anticipated; and

3. Whether the plant operates as anticipated in the siting docket.

No party in the present proceeding has raised any question concerning these aspects of the Jasper Plant and its construction.

In Order No. 2002-19, Docket No. 2001-420-E (the "Siting Order"), we held:

- The Company clearly demonstrated the need for the facility. (Siting Order at 11, 13).

- An 875 MW facility allows for economies of scale resulting in incremental capacity costs of approximately 60% of the cost of base capacity. (*Id.*)

- An 875 MW facility is within the demand forecast error bounds of the 2001 IRP and promotes increased reliability within the Company's territory and the Company's required VACAR reserve margin. *(Id.)*

- The Company's decision-making process which considered, but rejected purchased power, was adequate and prudent. The Company's knowledge of the electric markets and recent experience in its Urquhart Repowering Project made unnecessary an elaborate RFP process in reaching its final decision to construct Jasper. (*Id* at 12-13).

- The facility will serve the interests of system reliability and economy. (*Id.* at 13).

- Public convenience and necessity require the construction of the proposed facility. (*Id.* at 14).

In Order No. 2003-38 (the "2003 Rate Case Order") at page 32, the Commission found that the plant was properly designed to take advantage of valuable economies of scale in its construction. In that order, the Commission found:

1. Building the third Jasper unit at that time would reduce the cost of the plant by $111 million, compared to the cost of building only two units presently and adding a third later (2003 Rate Order at 32);
2. The third unit would be needed to serve retail demand in 2006 and that the procurement of equipment for it would have had to have begun before the present construction was completed (*Id.*);
3. The Company had been able to sell 250 MW of system capacity to third parties based on the reserves Jasper will represent when it comes on line;
4. Customers would be credited 100% of the value of this sale (*Id.*); and
5. Under South Carolina law, property that is prudently acquired for future utility use is used and useful and properly included in the rate base. (*Id. at 33).*

The Commission has consistently held that CWIP related to projects prudently undertaken and managed to provide utility service is indeed used and useful and properly included in rate base. Such was the case with the Jasper Project**.** (*Id.*).

In the present case, the Company seeks to put into base rates the balance of the costs incurred since the 2002 Rate Case in completing the Jasper project. "The law of the case [doctrine] applies both to those issues explicitly decided and those issues which were necessarily decided in [a] former case." *Ross v. Medical University of South Carolina,* 328 S.C. 51, 62, 492 S.E.2d 62-68 (1997). The doctrine prevents subsequent re-litigation of issues or claims actually litigated and decided in a prior suit. *Toal, Vafai*

& Muckenfuss, Appellate Practice in South Carolina, (2d ed. 2002). (The South Carolina Bar–CLE Division, 2002).

The failure to challenge an adverse ruling is an abandonment of the issue and precludes consideration of that issue in subsequent appeals. *Biales v. Young,* 315 S.C. 166, 432 S.E.2d 482 (1993); *Lindsay v. Lindsay*, 328 S.C. 329, 491 S.E.2d 583 (Ct. App. 1997). Ordinarily, an un-appealed order is the law of the case. *Charleston Lumber Co. v. Miller Hous. Corp.,* 338 S.C. 171, 525 S.E.2d 869 (2000); *Resolution Trust Corp. v. Eagle Lake & Golf Condominiums*, 310 S.C. 473, 427 S.E.2d 646 (1993); *Anderson v. Short,* 323 S.C. 522, 476 S.E.2d 475 (1996).

When an administrative agency is acting in a judicial capacity and resolves disputed issues of fact properly before it which the parties have had an adequate opportunity to litigate, courts have not hesitated to apply the doctrine of *collateral estoppel* to preclude further challenges. *Carman v. S. C. Alcoholic Beverage Control Comm'n.* 317 S.C. 1, 451 S.E. 2d 383 (1994). In *S.C. Coastal Conservation League v. S.C. Dep't of Health and Envtl. Control, Bureau of Ocean and Coastal Resource Mgmt.*, No. 97-ALJ-07-0763-CC, 1998 SC ENV LEXIS 49 (ALJ Div. Apr. 14, 1998), the court stated, "[t]his tribunal is not in a position to grant relief to persons choosing not to act, whatever the underlying motivation. Petitioners' failure to move for intervention in the prior contested case proceedings deprived this tribunal of any discretion to grant relief, as an agency is bound by its own order." (citation omitted). As the Court stated in *S.C. Coastal Conservation,* "[t]o allow collateral attack of an Administrative Law Judge's final order by a nonparty with notice of, and an opportunity to intervene in, a contested case proceeding would result in endless litigation. After all due process requirements have been met, this tribunal has a duty to preserve the public trust in the integrity of rights acquired on the faith of the adjudicatory process." (*Id.*)

Through Dr. Dismukes' testimony, Columbia Energy, LLC (Columbia Energy) seeks the Commission's review of issues fully and finally resolved in the Jasper Facility Siting Docket and the 2002 SCE&G Rate Case. Columbia Energy was noticed, pursuant to the Commission's rules, of both those dockets and did not intervene. It is, therefore, inappropriate for Columbia Energy to now attempt to attack issues already settled. We hold that the matters discussed by Dr. Dismukes have already been adjudicated by the Commission's prior orders and, therefore, the Commission will not reconsider these matters in this proceeding.

However, even if it is assumed that all of the foregoing issues as to need, size, prudence, and the used and useful nature of the Jasper facility, and the benefits of the NCEMC contracts were before the Commission in this proceeding, the evidence of record fully supports the resolution of all of these issues in favor of the Company.

B. COLUMBIA ENERGY'S MOTION TO STRIKE TESTIMONY

By written motion, dated, served, and filed on October 28, 2004, Columbia Energy moved to strike portions of the Rebuttal Testimony of Company Witness Neville O. Lorick[3] on the grounds that certain factual assertions lacked foundation in the record and, therefore, Mr. Lorick's testimony was hearsay, precluded from consideration by S.C. R. of Evid. 802. The Commission agreed with Columbia Energy and ruled from the bench excluding this testimony, which was not entered into the record in this case. (TR Vol. 1 at 32; Vol. 5 at 1510-11).

IV. STIPULATION OF CERTAIN PARTIES (FINDING OF FACT NO. 4)

At the outset of the proceedings in this matter, the Company moved into the record, as Hearing Exhibit One, a Stipulation and Settlement of the Staff of the PSC and SCE&G, dated October 18, 2004 ("Stipulation and Settlement"). Attached thereto and entered as a part thereof, were the written concurrences of SCEUC, SMI, and Wal-Mart. The Stipulation and Settlement, with concurrences, was filed with the Commission on October 29, 2004.

By the terms of the Stipulation and Settlement, the parties thereto agree to an increase in the Company's electric retail rates which will produce an additional $51,149,000.00 in revenue. The result is a decrease of $30,043,000.00 from the Company's requested $81,192,000.00 --a 37.0% reduction in the Company's request. The parties have further stipulated and agreed that a fair and reasonable Return on Common Equity (ROE) should be in a range of 10.4% to 11.4% and further stipulated that for setting rates the mid-point of the range, 10.9%, should be used. The parties also stipulate that the proper capitalization for determining SCE&G's rates and charges shall be the capitalization as of August 31, 2004, as set forth in the Staff Report.

The Stipulation and Settlement contains the following terms concerning severability and precedential value:

> *The Parties' agreement to this stipulation is based on the result reached, which is a net revenue increase to SCE&G of $51,149,000 and it is not any way severable as to specific issues or matters contained herein. Nothing contained herein shall*

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[3] Page 8, Line 18 through Page 9, Line 7.

> *constitute an admission by any Party as to any specific issue or ruling or shall be considered precedential in any future proceeding.*

Stipulation and Settlement at 7.

The entry of this exhibit into the record was opposed by Columbia Energy on the grounds that it contained conclusions of law and that it was not joined in by all parties. The Company and Staff asserted that the Stipulation and Settlement was admissible as a declaration of the parties of record, submitted to the Commission for consideration as a compromise resolution of issues. As an evidentiary matter it was supported by prefiled testimony of the Staff and the Company. (TR Vol. 1 at 40-43, 57-58, 75).

Settlements by the parties to litigation are encouraged by the laws of South Carolina. S.C. Code Ann. § 58-4-450 (A)(9) specifically encourages the settlement of issues by parties before the Commission, as does the case law of the state. See *Lawson v. Sumter County Sheriff's Office* 339 S.C. 133, 528 S.E.2d 86 (2000). *See also* S.C.R.Civ.P. 16(a). To this end, by way of further example, the courts of this state have adopted Alternative Dispute Resolution Rules and Rules for Family Court Mediation.

While the settlement of issues by parties is, and should be, encouraged, the Commission, nevertheless, must review such agreements to insure that they are in the public interest and do not negatively impact the regulatory process. See *Boston v. Barnes*, 294 S.C. 261, 363 S.E.2d 888 (1987). In the present case, the Commission has been afforded full opportunity to independently assess whether the proposed Stipulation and Settlement is in the public interest. This independent assessment has been carried out in accordance with the applicable statutory standards for rendering a decision in an electric rate case. The Commission has conducted full evidentiary hearings on all issues involved in SCE&G's original rate increase Application, and, concurrently, has tested the reasonableness of the proposed Settlement.

As other public utility commissions and appellate courts have recognized, nonunanimous settlements require Commission review to determine their reasonableness. *ARIPPA v. Pa. Public Utility Comm'n*, 792 A.2d 636, 659 (Pa. Commw. Ct. 2002) quoting Stefan H. Krieger, *Problems for Captive Ratepayers in Nonunanimous Settlements of Public Utility Rate Cases*, 12 Yale J. on Reg. 257, 265 (1995).. As the Kansas Court of Appeals has stated: "Unquestionably, the Commission may accept a nonunanimous settlement agreement provided an independent finding is made, *supported by substantial evidence in the record as a whole*, that the settlement will establish just and reasonable rates." *Citizens' Util. Ratepayer Bd. v. The State Corp. Comm'n of the State of Kansas*, 16 P.3d 319, 323 (Kan. App. 2000), (citation omitted); (emphasis in italics added).

The Commission realizes that in considering a non-unanimous settlement, it must not unwittingly shift the burden to the non-consenting parties by forcing them to prove the unreasonableness of the settlement. In the present case, the Commission has not impermissibly shifted the burden of proof to the parties that are non-participants to the Stipulation and Settlement. All parties have been afforded ample notice and opportunity to test the reasonableness of the Stipulation and Settlement in the course of the evidentiary hearings before the Commission. The non-participating parties to the Stipulation and Settlement conducted extensive discovery and vigorous cross-examination of a number of Staff and Company witnesses. They have been allowed to fully litigate all issues before the Commission in this matter.

This Commission has made an independent assessment of the Stipulation and Settlement to enable it to ascertain whether accepting the Stipulation and Settlement would produce just and reasonable rates in this proceeding. With or without the Stipulation and Settlement, the evidence on the record provides the Commission with adequate and precise information for the establishment of the revenue and rate matters at issue here, e.g., rate base, operational expenses and taxes including depreciation, rate design, cost of service and the rate of return requirement. Consequently, the Commission is able to exercise its own independent assessment and judgment on whether accepting the Stipulation and Settlement is in the public interest. The Stipulation and Settlement will be reviewed in light of the substantial evidence on the record as a whole to allow the Commission to make a detailed and independent judgment concerning the appropriateness of the resolution to the case that it advances.

At the hearing in this matter, the parties conducted substantial cross examination concerning the terms of the settlement and how it was developed. (TR Vol. 4 at 1317-1325, 1332-1342, 1344-1349, 1351-1352, 1388-1414, 1417-1420, 1421-1460; TR Vol. 5 at 1492, 1495-1509, 1524-1526, 1530-1532, 1542-1551). The record shows that the participating parties to the Settlement conducted substantial, vigorous and good faith negotiations. (TR Vol. 4 at 1393-1394; TR Vol. 5 at 1546-1550). The Staff did not enter into these negotiations until it first had conducted its own independent audit, had developed the various accounting adjustments affecting Applicant's requested revenue requirement and rate increase, and had incorporated its own derived estimate of the rate of return requirement for SCE&G's regulated electric operations. (TR Vol. 4 at 1338, 1395-1397, 1421-1429, 1436-1438).

In short, Staff had fully developed its litigation positions in this case adjudication *prior* to the commencement of substantive settlement negotiations with SCE&G. For example, both Staff Witnesses Scott and Watts testified that Staff's audit and accounting adjustment work and positions had been essentially finalized before proposed settlement negotiating positions were considered. (*Id.*) Under cross-examination by Mr. Knapp, Staff Witness Pilalis testified that he finalized and forwarded to the Staff offices his return on common equity estimate and recommendation on October 13, 2004, and that he then participated in settlement discussions on October 15, 2004. (TR Vol. 5 at 1497-98). Applicant's Witness Lorick testified on rebuttal under cross-examination that the Staff was not willing to accept a revenue requirement and the setting of rates for SCE&G on the basis of an 11% ROE. (*Id.* at 1546-1547). In contrast, the Company's litigation position provided evidentiary support for an ROE far in excess of 11%. (See this Order, *infra.*).

A number of Company witnesses stated on the record that the terms and conditions of the Stipulation and Settlement present risks and challenges to SCE&G's electric operations, and that the Company must strive to perform so that it can successfully meet the requirements of the Settlement and meet the expectations both of its customers and of the financial investment community. (TR Vol. 1 at 295-298, 318-319; TR Vol. 5 at 1531-1532, 1545-1549, 1716-1719).

The Stipulation and Settlement presents to the Commission a reasonable alternative for the resolution of the issues that the Settlement addresses. The main elements it addresses,--Applicant's rate of return, revenue requirement, rate increase request, and rate design-- are within the litigation positions of Staff, SCE&G, and the Energy Users Committee. Therefore, the Commission agrees with Staff and the Company and admits Hearing Exhibit One into the Record. The Commission will consider the Stipulation and Settlement as a statement of the position of the parties concerning an acceptable and supportable compromise resolution to the issues presented in this case.

V. EVIDENCE AND CONCLUSIONS

The evidence and conclusions supporting the findings of the Commission in this matter are as follows:

A. EVIDENCE AND CONCLUSIONS CONCERNING THE COMPANY'S BUSINESS AND LEGAL STATUS

(FINDING OF FACT NO. 1)

The evidence supporting the finding concerning the Company's business and legal status is contained in the Company's Application and in prior Commission Orders and docket files of which the Commission takes judicial notice. This finding of fact is essentially informational, procedural, and jurisdictional in nature, and the matters it involves are uncontested.

B. EVIDENCE AND CONCLUSIONS CONCERNING THE TEST PERIOD

(FINDING OF FACT NO. 2)

The evidence for this finding concerning the test period is contained in the Application of the Company and the testimony and exhibits of Company witness Carlette L. Walker (TR Vol. 2 at 685-687, 701) and Staff witness Sharon G. Scott (TR Vol. 4 at 1286-1287). A fundamental principle of the ratemaking process is the establishment of a test-year period. Reliance upon the test year concept, however, is not designed to preclude the recognition and use of other historical data which may precede or post date the selected twelve month period where it is appropriate to do so.

Integral to the use of a test year is the necessity to make normalizing adjustments to the historic test-year figures. Only those adjustments which have reasonable and definite characteristics and which tend to influence reflected operating expenses are made in order to give proper consideration to revenues, expenses, and investments. *Parker v. South Carolina Pub. Serv. Comm'n*, 280 S.C. 310, 313 S.E.2d 290 (1984). Adjustments may be allowed for items occurring in the historic test year but which will not recur in the future, or to give effect to items of an extraordinary nature by either normalizing or annualizing such items to reflect more accurately their annual impact, or to give effect to any other item which should have been included or excluded during the historic test year. The Commission finds the twelve months ending March 31, 2004, to be the reasonable period on which to make its ratemaking determinations.

C. EVIDENCE AND CONCLUSIONS CONCERNING REVENUES, EXPENSES AND INCOME

(FINDINGS OF FACT NOS. 3, 5, 7-10; 13-21; 23-31)

1. Contested Adjustments and Adjustment Requiring Discussion

i. Annualizing Revenues from the NCEMC Contract (Company Pro Forma No. 1; Staff Pro Forma No. 1)

The Company has entered into two contracts for the sale of capacity and energy to North Carolina Electric Membership Corporation ("NCEMC"). One contract is for the sale of 100 MW for a term of two years. The other is for the sale of 250 MW for a term of 9 years. Both of these contracts went into effect at the beginning of the fourth quarter of the test period. (TR Vol. 2 at 690). As a result, revenues related to these contracts must be annualized to properly reflect their impact over a full 12 month period.

In its Application, the Company proposed a pro forma adjustment to increase test year income by $30,099,357 to reflect the revenue impact of a full 12 months of the two contracts. (TR Vol. 2 at 690-91). The $30 million adjustment includes a) the fixed monthly capacity charges contained in both contracts, and b) the margin revenue anticipated to be generated by energy charges under both contracts. As to this latter amount, the Company directly allocates its actual cost of fuel to the sales under the contracts on an after-the-fact basis . The fuel price charged NCEMC under the contract may vary from this actual cost. To the extent the actual fuel cost is less than the contract charge for fuel, energy margin revenue is generated. If the reverse is true, there is a negative energy margin or loss on the energy component of the sales.

With reference to the 100 MW sale, the pricing terms of that contract generate positive energy margins on a consistent basis. These margins are reflected in the $6.8 million in annual energy margin anticipated under the 100 MW contract. (Hearing Exhibit 15; TR Vol. 2 at 708). However, concerning the 250 MW sale, Mrs. Walker testified that the Company has established the pricing terms so that over time, revenue from energy sales under that contract will equal fuel costs, and margin revenue will balance to zero. (TR Vol. 2 at 707, 726). . Mrs. Walker further testified that during the initial months the contract was in force, there have been periods when the energy component of the contract has produced net revenue (January-March: $1.005 million) and periods when it has produced net losses (April-May: -$737,033). (TR Vol. 2 at 707). But over time, the gains and losses are expected to balance to zero. (TR Vol. 2 at 707, 726).

The Company proposed a pro forma adjustment to reflect the net energy margin revenue earned under the 250 MW contract from January 1 through May 31, 2004, which was $310,688. (Application at Pro Forma No. 1; TR Vol. 2 at 708). The Company does not, Mrs. Walker testified, have any basis to assume or predict that positive margin revenue will be generated on an on-going basis and so additional revenue beyond March 31, 2004 was not forecast. (TR Vol. 2 at 708, 726). The Commission Staff has reviewed the adjustment and proposed no change except that certain gross receipt taxes related to the transaction have been omitted. The amount of those taxes is $141,808. (TR Vol. 4 at 1294). The parties to the Stipulation and Settlement, including the Commission Staff, agreed to the pro forma adjustment as proposed by the Company, and the gross receipts tax adjustment identified by the Staff. (Stipulation and Settlement at 5).

The Consumer Advocate's Witness Mr. Watkins proposed increasing the assumed margin revenue from the 250 MW contract by annualizing the results for January 1 through May 31, 2004. (TR Vol. 4 at 958). He proposed this adjustment based on his claim that he could not verify that margin revenue would balance to zero because the underlying contracts had not been provided for his review. (TR Vol. 4 at 958).

In fact, the record shows that the Consumer Advocate was not denied access to these contracts. Instead, the record shows that the Company specifically offered to provide copies of the contracts to all parties (apart from its competitor, Columbia Energy, LLC) under confidentiality orders or agreements. (TR Vol. 2 at 709). The Consumer Advocate did not seek to avail itself of this offer. (TR Vol. 2 at 709). The Commission finds that Mr. Watkins' argument in this regard is without merit.

The Commission finds Mrs. Walker's testimony to be credible concerning the fact that the Company has structured the pricing terms of the 250 MW contract such that energy revenue and fuel costs will balance to zero over time and that the results during the initial period were atypical. (TR Vol. 2 at 707-708, 726). The Commission does not find there to be a suitable basis on the record in this case to assume that the 250 MW contract will generate net energy margins equivalent to those experienced in the January-May period on an on-going basis. (*See* TR Vol. 2 at 707-708, 726). The Commission finds no basis to ignore Mrs. Walker's testimony, and to assume that the imbalance in energy revenue and expense experienced in the initial months will in fact be experienced consistently over succeeding months. (TR Vol. 2 at 708). In this regard, the Commission notes that the imbalances experienced to date are relatively minor compared to the total volume of energy revenue and energy costs related to contract. (Hearing Exhibit 15, 16).

In addition, the Commission finds persuasive Mrs. Walker's testimony that an updating of the pro forma adjustment to reflect results of actual experience January-August 2004 under both contracts would result in a net decrease in revenue recognized by the pro forma, not an increase as Mr. Watkins proposes. (TR Vol. 2 at 708; Hearing Exhibit 16). The amount of that decrease in the pro forma adjustment would be

$674,510. (TR Vol. 2 at 708; Hearing Exhibit 16). In light of the above, and the Stipulation and Settlement by five parties to the adjustment as proposed, the Commission adopts the adjustment as contained in Mrs. Walker's testimony and the tax related adjustment proposed by the Commission Staff. (TR Vol. 2 at 690-91; Vol. 4 at 1294).

ii. Proposed Segregation of the NCEMC Contract from the Retail Electric Rate Class (Columbia Energy Pro Forma No. 1)

Through the testimony of its witness, Dr. David Dismukes, Columbia Energy proposes that the Commission exclude from retail electric rate base the 48% of the Jasper Plant investment that was not included in CWIP in SCE&G's last electric rate case, and also remove from consideration in setting retail rates the revenues related to the NCEMC contracts. (TR Vol. 3 at 1041, 1060). The basis for this proposal is the assertion that the additional Jasper Plant investment is not used and useful for serving retail electric customers. (TR Vol. 3 at 1060).

As discussed above, the Commission has conclusively ruled in past dockets that there were substantial benefits to SCE&G's customers from building the Jasper Plant in its 875 MW configuration when supported by revenues from the 250 MW NCEMC sale. Implicit in the Siting Order and in the 2003 Rate Order is the finding that when constructed and placed in service in the 875 MW configuration, the Jasper Plant would indeed be used and useful for serving retail customers. The testimony of the Company's witnesses Mr. Lorick and Dr. Lynch in the present docket fully substantiate that conclusion. Accordingly, the premise on which Dr. Dismukes suggests excluding part of the Jasper Plant investment from retail rate base cannot be sustained.

Furthermore, the Commission finds that the rate making treatment of the two NCEMC sales as proposed by the Company is fully consistent with the substance of those transactions and the regulatory principles that govern them. (TR Vol. 5 at 1591). The transactions in question reflect "system firm" sales of electric capacity. (TR Vol. 5 at 1564-65). Such sales are sales under which the customer, NCEMC, will receive the benefit of the capacity in question only to the extent that capacity is not required to serve native load (*i.e.,* South Carolina system) customers. Of greater importance, however, is the fact that the two sales in question were made pursuant to a plan placed before this Commission in the Jasper siting Docket to construct the Jasper Plant in its 875 MW configuration, and support the larger plant in its initial years through the revenues generated by the sale of 250 MW of system firm capacity to NCEMC. (TR Vol. 5 at 1591). This combination of capacity and revenue was approved by this Commission in the Siting Order for the Jasper Plant. SCE&G has implemented this approved strategy in constructing the plant at 875 MW of capacity and making the 250 MW sale. (TR Vol. 5 at 1591). SCE&G has further increased the benefit to customers under this approach by negotiating an additional 100 MW sale for the first two years the Jasper Plant is in service. (TR Vol. 5 at 1591). Thus, what SCE&G has presented the Commission in this proceeding is what the Commission approved in its Jasper Siting Order.

In addition, the proposal coupling the increased size of the Jasper facility with the revenues from NCEMC sale was made as a single package, with the intent that all NCEMC revenues would be used to defray system costs and that the sale of capacity and energy to NCEMC would be a system sale. (TR Vol. 5 at 1591). As Company witness Marsh testified:

> The most appropriate way to reflect these sales is to ascribe the revenue to the system as a whole. This treatment properly reflects the fact a) that the sales are system sales and not unit specific sales, and b) that the 875 MW Jasper configuration, and the 250 MW NCEMC sale, were presented and approved as a unified package for the SCE&G's electric system as a whole. To now segregate out parts of the Jasper investment and parts of system revenue for special treatment is inconsistent with the basis on which the plant was sited, the basis on which the 250 MW sale was negotiated, and the basis on which the opportunity sales are supplied with system capacity. It would also require the Commission to give different regulatory treatment to the 250 MW sale than it gives to other similarly situated sales.

(TR Vol. 5 at 1592).

It was further the intent of the Commission that all Jasper capacity would remain part of SCE&G's retail electric rate base fully available to serve retail customers when required. Today, the Jasper Plant is SCE&G's most efficient gas fired generation unit. (TR Vol. 1 at 179). Its entire capacity is available to serve native load customers and in fact is used on a regular basis to serve SCE&G's native load customers. (TR Vol. 1 at 179, 228-29; Vol. 5 at 1568). SCE&G's customers get the full benefit of Jasper's fuel efficiency. (TR Vol. 1 at 178).

Dr. Dismukes suggests that it was improper to treat the two NCEMC sales as if they were non-firm, opportunity sales. (TR Vol. 3 at 1048-49). The Commission finds, however, that there is no single definition of what constitutes an opportunity sale in the electric industry, nor is there any requirement that the Commission find the NCEMC sales to be opportunity sales, or non-firm sales, to support the rate making treatment that is proposed here. However, opportunity sales have generally been considered to be sales made out of available generation capacity to generate margins to defray system costs. The revenue produced by opportunity sales is typically credited to electric system revenue, reducing the costs other customers must bear. (In some cases, the utility is allowed to keep a part of the revenue as an incentive for making the sale. In such cases, the balance of the revenue, however, is credited to customers as indicated above.) There is not a segregation of assets or expenses related to an opportunity sale.

The Commission finds that it is entirely appropriate to treat the NCEMC sales in this manner. They are sales from capacity made available as a result of constructing the Jasper Plant in its 875 MW configuration, a decision SCE&G made, with Commission approval, to save money for its customers over the long term. The NCEMC sales are sales that support the additional Jasper capacity and that capacity provides important benefits to customers both presently and in the future. This is exactly the result that was anticipated when the Jasper Siting Order was issued.

Dr. Dismukes argues that it is inconsistent to treat these NCEMC sales as the Company proposes and also for SCE&G to have included them in its reserve margin calculations. (TR Vol. 3 at 1048-49). The fact that SCE&G includes these sales in its reserve margin calculations is fully consistent with the fact that the revenues that they represent are important to the financial aspects of the plan under which the Jasper Plant was sited at the 875 MW configuration. (TR Vol. 5 at 1565). Clearly, customers share an interest in SCE&G not losing the benefits of these sales and SCE&G is acting consistently with the plan it presented in the Jasper Siting Docket by managing its system in a way that maintains its ability to generate these revenues for the benefit of customers.

The Commission finds, as Company Witness Dr. Lynch has testified, there are substantial savings to SCE&G's electric retail customers resulting from the decision to build the Jasper Plant as an 875 MW plant coupled with a 250 MW sale to NCEMC. (TR Vol. at). In fact, as Dr. Lynch testified, over the life of the plant, the savings to native load customers will be approximately $190 million compared to a 449 MW configuration and approximately $95 million as compared to a 620 MW configuration (which would produce a 23% reserve margin in 2004). (TR Vol. 5 at 1578, 1582).

The Commission finds fully credible Dr. Lynch's testimony that beginning in 2005 when the rates established in this Docket go into effect, the 875 MW Jasper Plant (supported by the NCEMC sale) is the less costly alternative to customers. Dr. Lynch's analysis is based on a comprehensive assessment of all costs related to the various alternatives available to the Company for meeting increasing customer demands. (TR Vol. 4 at 1125-1128); Vol. 5 at 1558). It does not, as is the case in Dr. Dismukes' analysis, look at capital and O&M costs alone and fail to consider the impact of alternative decisions on system dispatch and fuel costs. (TR Vol. 5 at 1568).

Further, Dr. Lynch's analysis reviewed the cost to customers of the 875 MW Jasper plant (with the 250 MW NCEMC sale) as compared to the next best alternative to the Company, a smaller plant with no sale. (TR Vol. 5 at 1568-69, 1577-78). Dr. Dismukes analyzes the 875 MW plant only in relation to the NCEMC sale and ignores the relative costs of the alternatives that the Company would have been required to pursue without the NCEMC sale. (TR Vol. 5 at 1577-78; Vol. 4 at 1125-1128). One effect of Dr. Dismukes approach is to ignore the fact that the additional capital and O&M expense related to the larger Jasper configuration are incremental to the costs that customers would have been required to bear under the smaller alternative configurations. (TR Vol. 5 at 1568). Dr. Dismukes instead assigns average capital and O&M cost to the incremental units of capacity, which overstates those costs in comparison to the alternative configurations. (TR Vol. 5 at 1568).

For these reasons, the Commission declines to adopt the proposal put forward by Dr. Dismukes and finds that accounting for the NCEMC sales as proposed by the Company fully captures these benefits for SCE&G's customers and is fully consistent with the basis on which the Jasper Plant was sited.

iii. Amortizing the Unrecovered Fuel Component of Purchased Power(Company Pro Forma No. 2; Staff Pro Forma No. 2)

Economy energy purchases are purchases of short term energy made from the electric grid when such energy is available at a price that is cheaper than the incremental cost of the next unit of the Company's generation. With the Commission's approval, SCE&G has historically treated the cost of that energy as a fuel cost, and passed it through to customers pursuant to fuel clause adjustment proceedings conducted pursuant to S.C. Code Ann. § 58-27-865. The logic of this approach was that the price paid for the energy was less than the avoided fuel cost of the energy SCE&G would have incurred in generating this energy.

The Consumer Advocate challenged this treatment of economy energy costs beginning in the Company's 2002 fuel clause proceeding. As a result of these challenges, the Company and the Consumer Advocate entered into a stipulation and settlement that was adopted by the Commission in Docket No. 2004-02-E. (Hearing Exhibit No. 38). The stipulation provided that the Company would reduce its under-collection amounts in that case by 60% of the disputed economy energy costs ($25,618,063). Under the settlement, the Company would then be authorized to amortize and collect the amounts in question in future rate proceedings.

The underlying dispute as to the recoverability of these costs through the fuel clause has since been resolved. By Section Seven of Act No. 175 of 2004, effective February 18, 2004, the South Carolina General Assembly has adopted an amendment to S.C. Code Ann. §58-27-865 which clarifies the General Assembly's original intent that 100% of the costs of economy purchases are properly included in fuel cost calculations. S.C. Code Ann. § 58-27-865(A)(2)(b)(2004). The General Assembly specifically couched the amendment as a clarification of its original intent and not a change in the language or meaning of the statute. (*Id.*).

The only dispute concerning this pro forma adjustment concerns the appropriate time period over which the amounts in question should be amortized. The Company has proposed to amortize the amount to be collected over 3 years, resulting in an annual expense of $8,539,354. The Consumer Advocate, through his witness Mr. Watkins, argues for collection over a five year period.

Mrs. Walker testified that the three year collection period is preferable based on the "general principle, [that] when dealing with costs that have accrued incrementally over time, it is preferable to choose amortization periods that reasonably correspond to the accumulation period." (TR Vol. 2 at 709). She testified that compared to a five year period, the three year period, "more closely matches the [two year] accumulation period and yet is long enough to spread the impact of the cost in a logical way." (TR Vol. 2 at 709). The parties to the Stipulation and Settlement have agreed to the 3 year amortization period. (Stipulation and Settlement at 4).

The Commission finds that Mrs. Walker's testimony in this regard is credible and that regulatory policy supports the matching principle she espouses. The Commission does not find that a longer amortization period is preferable or required. Specifically, the Commission does not believe that a three year period is improper because "it may be more than three years until SCE&G's next rate case" as Mr. Watkins argues. (TR Vol. 3 at 960). It is not possible to precisely time the end of any amortization period to the date on which a rate case will be filed or decided. In addition, utility expenses rise and fall, often in offsetting ways. In light of inflation and continued growth in demand and investment, there is no basis to conclude that future overearning will result from a three-year amortization of these costs. The Commission adopts the three year amortization period as proposed by the Company and set forth in the Stipulation and Settlement.

iv. Annualizing Turbine Maintenance (Company Pro Forma No. 4; Staff Pro Forma No. 5)

SCE&G proposes that it be allowed to annualize the Operating and Maintenance (O & M) costs for the generating turbines located on its system. This proposal would adjust these expenses to levelize the costs of an eight (8) year maintenance cycle for the turbines. The purpose of the proposed adjustment is to properly match maintenance expenses with the year-by-year use of the generating facilities that cause such expense to be incurred. Such adjustments are part of the Commission's long-standing process of "annualizing such items to reflect more accurately their annual impact." (Order No. 2003-38 at 9) (TR. Vol. 2 at 692). The parties to the Stipulation and Settlement agreed that levelizing the costs over an 8 year period is appropriate.

To ensure no party benefits from over or under collections, the Company proposes to match the actual costs incurred for turbine maintenance O&M each year to the expense level allowed in this case, and book any over or under-collections to regulatory asset or liability accounts subject to further orders of this Commission. The parties also agreed in the Stipulation and Settlement that the Company will accrue interest on the balance of any net overcollection resulting from this mechanism at the overall rate of return approved by the Commission in this proceeding. Therefore, the Company would not experience a "windfall" or loss due to the amount of O&M expense incurred in any year. Further, the Company will file a report concerning the results of this mechanism reflecting data as of the end of calendar year 2007 for Staff review. The effect of the adjustment is to increase SCE&G's expenses by $5,412,193. (TR Vol. 2 at 692).

The evidence shows that these turbine maintenance expenses are predictable costs that will be incurred due to the operation of the plants (TR Vol. 2 at 747). Staff Witness Watts testified that in the audit of the Company conducted by the Commission Staff in this proceeding, the Company provided detailed information to the Staff, and in turn to other parties, supporting the schedule, nature and projected expense of this maintenance. (*See* Hearing Exhibit No. 37) (TR Vol. 4 at 1421 – 1422). Staff also made a comparison to similar maintenance costs of another utility and found SCE&G's costs to be reasonable.

As testified by Staff witnesses and by Company Witness Marsh, the approach that the Company is taking as to this maintenance is more economical than the turbine manufacturer's proposed "turn-key" fixed-price contract. That contract would have provided ongoing maintenance to the gas fired turbines at a significantly higher cost than the Company is projecting. However, the levelized annual payment under a fixed-price contract would not have been subject to the objections that other parties have made to the Company's levelization proposal here. (TR Vol. 5 at 1602).

We find that the maintenance of these turbines is an engineering requirement that will be conducted on an ongoing basis. These are maintenance expenses and are not of a capital investment nature. (TR Vol. 5 at 1600–1601). Detailed and prescriptive schedules of required maintenance dictate the nature and schedule of the work that will be performed to the turbines making these costs both known and measurable. (TR Vol. 5 at 1601).

Sound regulatory policy supports levelizing these maintenance costs. Levelization allows for these maintenance expenses to be matched to the provision of service that causes these expenses to be incurred. To put it another way, unless these costs are levelized, current customers will not pay the full cost of the service they are receiving. Levelization also leads to more stable rates, because recovery of these costs will not depend on whether a future test period includes a high or low level of maintenance expense. Further, by allowing the Company to levelize the costs as proposed, the Commission does not create a bias in favor of more expensive turn-key maintenance contracts offered by manufacturers. The Commission finds that levelizing the maintenance costs in this manner will be beneficial to customers, allowing the Company to track and recover the costs in an appropriate fashion. The Commission approves the adjustment and the proposed 8 year maintenance-cycle plan for O&M turbine expenses in accordance with the evidence and the Stipulation and Settlement.

v. Pension and Health Care Related Adjustments –Health Care (Company Pro Forma No. 8)

As in past cases, the Company has included in its Application a pro forma adjustment to annualize the level of test year health care costs to reflect its most recent experience, in this case the period January-March 2004. The Consumer Advocate, through its witness Mr. Watkins, has suggested that in making the adjustment for current health care costs, the Commission should rely on Department of Labor figures for health care cost inflation rather than on an annualization of SCE&G's most recent actual experience. (TR Vol. 3 at 965). Mr. Watkins based his proposal on what he saw to be significant fluctuation in SCE&G's actual monthly health care costs in the first quarter of 2004. (TR Vol. 3 at 965-66).

In response, Mrs. Walker, in rebuttal testimony, recalculated SCE&G's actual health care cost experience using the most recent data available at the time of hearing, which included the period January-August 2004. (TR Vol. 2 at 710). The actual experience during this eight month period resulted in an annual health care expense of $30,182,204 compared to an annual expense projected at $30,161,988 based on the January-March data used in calculating the pro forma. The difference is an increase of only $20,216. (TR Vol. 2 at 710). The Commission finds that this additional data fully validates the pro forma adjustment as proposed by the Company and adopts that adjustment.

vi. Adjusting Long-Term Disability Expense (Company Pro Forma No. 9; Staff Pro- Forma No. 11)

In 1992, the Financial Accounting Standards Board adopted FAS 112, which required employers to book liabilities associated with future long-term disability payments to employees. (TR Vol. 4 at 1176). Before that time, companies were permitted to treat these liabilities on a pay-as-you-go basis regardless of the materiality of the future obligations. Under pay-as-you-go, companies recognize expense only at such time as payments are made to disabled employees.

Under Generally Accepted Accounting Principles, the booking of liabilities are required only if a materiality standard is met. However, as the Company Witness Walker testified, the passage of the Sarbanes-Oxley Act has resulted in a stricter application of accounting standards, and the Company and its external auditors now apply a much lower threshold of materiality in evaluating such matters. (TR Vol. 2 at 711). Reviewing the FAS 112 liabilities against current materiality standards, the Company has accrued an $8.3 million liability for future payments to employees currently receiving benefits. As Mrs. Walker testified: "The recognition does not reflect a change in the amount of the liability. Instead, it means that the Company must accrue these amounts in a forward looking manner, as required by current Generally Accepted Accounting Principles, rather than recognizing them as expenses on a 'pay-as-you-go' basis, as was proper when the amounts were deemed to be immaterial." (TR Vol. 2 at 711-12). The Commission Staff and the parties to the settlement have all recognized the appropriateness of booking these liabilities as the Company has done. (Stipulation and Settlement at 7; TR Vol. 4 at 1297).

The Navy's witness, Mr. Smith, opposed the adjustment testifying on several grounds. First, he asserts that there is no need to amortize the amounts in question. He testified that the deferred asset and the associated liability for payment of future benefits "balance" such that there is "no net amount that would be required to be amortized into future expense for ratemaking purposes." (TR Vol. 4 at1177). However, as Mrs. Walker testified, a deferred asset can be amortized only as amounts are collected through rates. (TR Vol. 2 at). As a result, unless the amortization is allowed, there is no means for the deferred asset to be reduced.

Second, Mr. Smith argues that the adjustment should be denied since the Company did not recognize the expense in 1994. However, the Commission accepts as credible Mrs. Walker's testimony that the Company did not deem the amounts in question to be material at that time and therefore Generally Accepted Accounting Priniciples did not require the liability to be recognized. (TR Vol. 3 at 774-75). The Commission further recognizes the tightening of materiality standards that has occurred since passage of the Sarbanes-Oxley Act. Accordingly, the Company's reevaluation of the materiality of these FAS 112 liabilities was appropriate. The Commission finds that the Company's recognition of these obligations for the first time in the present context is not improper in any way.

Third, Mr. Smith argues that the amortization should be denied because the Company did not seek an accounting order in March of 2004, when the liability was booked. However, as Mrs. Walker testified,

> *[t]his deferral was made with the understanding that the Company would seek approval for the deferral and the amortization in this proceeding, as in fact it is doing. The test for recognizing such a deferral before an order is issued is well established in accounting practice. The test is whether the deferral is consistent with past Commission practices and policies, which this deferral and amortization clearly is. For example, the proposal is fully consistent with the Commission's treatment of the transition obligation associated with the adoption of FAS 106, which was granted in 1993 in Order No. 93-465.*

(TR Vol. 2 at 711). The Company's position on this matter is indeed consistent with accounting standards and past Commission action on similar matters, and the Commission affirms it.

Finally, Mr. Smith argues that the amortization should be denied since the amounts in question are expenses related to past periods. As Mrs. Walker testified, this is not factually accurate. The amounts in question relate to "future payments owed to employees who qualify for benefits from this program today." (TR Vol. 2 at 712). The Company is properly including in its expenses the accrual of new liabilities and there is no double counting of expenses.

The Commission finds that these expenses are indeed valid expenses of the Company which must be recognized under FAS 112 given their materiality under current standards. The accrual and amortization of these expenses is consistent with past Commission practice and sound regulatory policy. (TR Vol. 3 at 817-19).

The Commission Staff has proposed that the $8.3 million liability be amortized over nine years, not the five years proposed by the Company. The nine year period reflects the period (actuarially determined) over which benefits will be paid to the employees presently receiving benefits under the plan. (TR Vol. 4 at 1297). This proposal has been accepted by the Company and the other parties to the Stipulation and Settlement . (Stipulation and Settlement at 4). The Commission accepts this adjustment in the amortization period for the reasons set forth in Staff's testimony.

vii. Property Additions for NERC Compliance –New NERC Standards (Company Pro Forma No. 13; Staff Pro Forma No. 16)

SCE&G proposes to adjust Plant in Service and O&M expense for costs of compliance with new, mandatory North American Electric Reliability Council (NERC) standards related to increasing and enhancing electric system reliability. These standards will go into effect in 2005. The standards were adopted in response to the black-out affecting the Midwestern and northeastern states during the summer of 2003. This adjustment increases plant in service by $1,309,000 ($240,000 of which is computer software to be amortized over five years), increases O&M expenses by $1,050,000, and increases amortization expense by $48,000. (TR Vol. 2 at 696 and 712 – 713; Hearing Exhibit No. 15).

Eight (8) new employees must be hired by SCE&G in order for SCE&G to fulfill the responsibilities of the NERC requirements, including performing reliability monitoring and coordinating functions. Employees for these positions currently are being hired by the Company. SCE&G used an average of the salaries for the positions, based upon a market analysis of the positions and the salaries they warrant, as offers for the positions had not yet been extended as of the filing of this matter. (TR Vol. 3 at 785 – 787). The computer hardware and software being purchased and installed will support the reliability monitoring and coordinating functions for the stability and security of the electric grid. (TR Vol. 2 at 712).

The Department of the Navy, the Consumer Advocate, and the Staff did not agree with this adjustment, stating that the costs were not known and measurable.

The Commission approves this adjustment. The costs detailed here are in fact known costs of complying with mandatory NERC requirements. The new employees will be hired, and the new computer hardware and software will be purchased, installed and configured. This work and these hirings must be completed prior to the beginning of 2005 and prior to rates going into effect from this proceeding. The costs are fully measurable in that the number of new employees and their compensation have been established. (TR Vol. 2 at 713). We believe it appropriate for SCE&G to recover these costs. The parties to the Stipulation and Settlement have agreed that the Company's position on this matter, as filed in the Application, is appropriate (Stipulation at 7).

viii. Saluda Dam Remediation Project (Company Pro Forma No. 18)

The Saluda Dam was completed in 1930, impounding the waters of the Saluda River, resulting in the formation of Lake Murray. Since the primary purpose for which the dam was originally constructed was hydroelectric generation, the dam is under the jurisdiction of the Federal Energy Regulatory Commission (FERC). Lake Murray is also the source of cooling water for the Company's McMeekin Steam Plant and provides drinking water for the City of Columbia and adjacent communities, and is a major recreation area and residential community. (TR Vol. 1 at 111).

After extensive investigations beginning in 1989, FERC ordered a major remediation project for the Saluda Dam to be implemented in the 2002-2005 time-frame. The remediation was to be accomplished by the construction of a new supplementary dam, downstream of the existing dam. The Company anticipates completion of the remediation project by May 2005, and has already begun FERC-authorized refill of Lake Murray. (*Id.*) The total estimated project cost for this remediation is approximately $287,000,000.00. (TR Vol. 1 at 83). The Company has developed a strategy to finance the new dam in a manner which will not impose a rate increase on its customers. This is being accomplished through the utilization of synthetic fuel tax credits. (TR Vol. 1 at 83, 113, 277-278). On June 21, 2000, the Commission issued an accounting letter addressing the treatment of the synthetic fuel tax credits, and in Docket No. 2002-223-E, the Company requested that the Commission not include in rates the construction costs related to the remediation project. (TR Vol. 2 at 616).

The Company now proposes that the Commission authorize holding the investment in the remediation project outside of rate base and offsetting its after-tax construction costs with the synthetic fuel federal income tax credits generated by the Company's involvement in projects that produce synthetic fuel consumed on its system, net of the operating losses incurred by those partnerships. The Company officials have testified that it is their belief, at this time, based upon all known information, that the entire cost of the remediation project can be offset by the use of these tax credits, saving the customers an estimated $35,000,000.00 annually, had the cost of the project been recovered through rates. Under current assumptions, the Company will not collect revenues nor earn any return from customers on this investment. (TR Vol. 2 at 615-620).

The Commission applauds the leadership of the Company for developing a means of accomplishing the important remediation of the Saluda Dam without imposing the costs of this project on its customers. The Commission is particularly pleased that the Company proposes to utilize its synthetic fuel tax credits for the benefit of its customers rather than its shareholders.

The Commission recognizes the importance of the accounting treatment to be adhered to in connection with these tax credits and their ongoing availability to the

Company; therefore, the Commission specifically approves the Company's specified request, as follows[4]:

- A remediation project account will be established outside of rate base where all remediation project costs will be accumulated.
- In January 2005, the Company will recognize depreciation against the remediation project in an amount equal to the pre-tax value of the balance of all synthetic fuel tax credits accrued as of that date.
- The Company will offset that after-tax depreciation expense by crediting net synthetic fuel tax credits to income on that date by recognizing a reduction in income tax expense.
- Similarly, as additional net synthetic fuel tax credits are generated in each quarter that follows, an amount of depreciation equal to the pre-tax value of those newly generated credits will be recognized, and corresponding credits will be booked to income.
- Synthetic fuel tax credits will be matched to depreciation against the remediation project account on a quarterly basis until the net balance of this account is zero, assuming sufficient credits are available.
- AFUDC would continue to be recorded through December 31, 2004. After January 1, 2005, the outstanding balance in the remediation project account will accrue carrying costs at the Company's weighted average cost of capital

[4] **NOTE TO ADVISORY STAFF:** The language following this footnote has been reviewed and approved by the Company's outside auditors. They advise the Company that the accounting necessary for the use of tax credits and other tax benefits to support the Saluda Dam Remediation costs can be supported if the language following this footnote is adopted as proposed. The Company would respectfully request that revisions to this language be avoided if at all possible.

rate as set in this proceeding. For purposes of computing ongoing carrying costs, the net present value of the cash benefit related to the future tax depreciation of the remediation project assets will be offset against the remediation project account balance on January 1, 2005, thereby reducing carrying costs.

If risks materialize that prevent successful implementation of the plan, as described above, then the Company will return to the Commission and pose corrective action at that time.

ix. Recognizing Jasper Generation Project Expenses and Investment (Company Pro Forma No. 17; Staff Pro Forma No. 20)

The Company has proposed pro forma adjustments to reflect the Jasper Plant in the test year. The Jasper Plant went into commercial operation on May 1, 2004, after the close of the test year. Accordingly, investment and test year expenses must be adjusted to reflect the start of commercial operations of the plant. As discussed above, the Commission has already determined the used and useful nature of the Jasper Plant, and the appropriate ratemaking treatment for Jasper capital costs and O&M expenses as they relate to the NCEMC contracts.

Plant in Service Adjustment-- The first aspect of this adjustment places into Plant in Service the total amount of the Company's investment in the Jasper Plant as of May 31, 2004, which is $506,039,714. It also removes $501,599,418 related to the plant from CWIP accounts. None of the parties (except Columbia Energy as discussed with reference the NCEMC contracts) has objected to this aspect of the adjustment or the capital expenditures that it reflects. (TR Vol. 5 at 1608-09). The parties to the

Stipulation and Settlement have affirmatively agreed to it. (Stipulation and Settlement at 3). The Commission accepts this adjustment and finds that the capital investments it reflects are prudently incurred investments that properly form part of SCE&G retail electric rate base.

Depreciation and Property Taxes Expense –This Adjustment increases test year depreciation expenses and property tax expenses to reflect the fact the Company began incurring additional depreciation and property tax expenses when the Jasper plant was placed in commercial service. The depreciation expenses were calculated based on the rates set forth in depreciation study adopted by the Commission in this proceeding. Property taxes were calculated using the rates provided for in the negotiated fee in lieu of taxes agreement related to the plant. (TR Vol. 2 at 699).

None of the parties (except Columbia Energy as discussed with reference the NCEMC contracts) has objected to this aspect of the adjustment or the expenses that it reflects. The parties to the Stipulation and Settlement have agreed to the adjustment as set forth in the testimony of Company Witness Walker. (Stipulation and Settlement at 3). The Commission finds that this adjustment to test year expenses is proper.

O&M Expense Adjustment –This Adjustment recognizes the O&M expense (labor, materials, supplies, services, etc.) required to operate the new plant. The Company calculated this O&M expense on an annual basis to be $6,472,938 using detailed staffing, maintenance plans and other fixed cost requirements. (TR Vol. 2 at 699).

In its testimony, the Commission Staff, through its witness Ms. Scott, proposed that Jasper O&M expenses be calculated instead by annualizing actual expenses for the period

May through October 2004. (TR Vol. 4 at 1301). The Company challenged the accuracy of that approach. As Company Witness Walker testified:

> *The Company does not believe that these months [May-September] are indicative of the operating and maintenance expenses that will be experienced going forward given the atypical nature of costs during the initial months of start up. Part of the reason for the disparity is that employees at the plant continue to work on capital related activities and projects during the start-up period. The Company has reviewed the actual operating results, and adjusting for start-up related capital activities, our initial estimates have been fully confirmed. The Company's pro forma adjustment is correct as proposed.*

(TR Vol. 2 at 713)

As part of the Stipulation and Settlement, the Commission Staff and other parties to the settlement accepted the proposed adjustment. (Stipulation and Settlement at 3; *see also* TR Vol. 4 at 1301). Mrs. Walker's testimony concerning the accuracy of the adjustment as proposed has not been contraverted.

Based on the Stipulation and Settlement and the reasons set forth in Mrs. Walker's testimony, the Commission finds that the pro forma adjustment as proposed by the Applicant should be adopted. The Commission accepts as credible Mrs. Walker's explanation of why annualizing initial operating results does not provide an accurate measure of operating and maintenance expense for the plant on an ongoing basis.

<u>Fixed Pipeline Capacity Charges Adjustment</u> --This adjustment reflects the removal of the fixed pipeline charges related to the delivery of gas supplies to the Jasper Plant from the fuel adjustment clause calculation. This adjustment allows the fixed pipeline charges instead to be recovered through base rates set in this proceeding. The amount of these fixed pipeline charges is $15,292,800 per year. (TR Vol. 2 at 714).

The Commission finds the foregoing adjustments to be appropriate as discussed therefore approves same.

x. New Depreciation Study (Company Pro Forma No. 15)

No party has challenged the Company's new depreciation study as presented by Company Witness Spanos. Accordingly, the pro forma adjustment reflecting these new depreciation rates is uncontested. The Commission has reviewed Mr. Spanos' testimony and the depreciation study he conducted. (TR at Vol. 641-56). The Commission finds that the depreciation rates contained in that study are appropriate for use by the Company in determining depreciation expense related to its assets. The Commission therefore instructs the Company to use the new depreciation rates presented by Mr. Spanos for recognition of depreciation expense for all purposes, both regulatory and accounting, until further order of the Commission. The Commission further grants the Company's request that it be allowed to record depreciation expense going forward based on the rates associated with individual plant accounts, rather than in aggregate, as set forth in the depreciation study.

xi. Adjust Fossil Fuel Inventory (Company Pro Forma No. 19; Staff Pro Forma 22)

In this case, the Company proposes to recompute coal inventory. The adjustment will increase the value of the inventory to reflect current market prices and normal, typical inventory levels, so as to avoid a current aberration in coal inventory. Currently, SCE&G's coal inventory is unusually low because of a tight coal market and serious difficulties being experienced in rail transportation. These problems are beyond the control of any utility. SCE&G initially informed the Commission of these issues in its most recent fuel case, Docket Number 2004-2-E. (TR Vol. 1 at 122).

The Company adheres to operating policies designed to maintain an inventory of coal at each of its coal-fired plants sufficient to meet each plant's forecasted operating requirements. During the test period, the inventories have been atypically low for the reasons stated above. SCE&G states that it is making every effort to restore coal inventories to more normal levels. Therefore, the Company proposes to adjust coal inventory to more accurately reflect typical levels for use in the test year calculations. The effect of the adjustment increases rate base by $13,256,666. The Commission Staff agreed with the Company's adjustment. (TR Vol. 2 at 701; Vol. 4 at 1302). The Settlement and Stipulation also supported this adjustment (Stipulation and Settlement at 5).

The Commission finds that this adjustment is appropriate. Sound regulatory policy is served by "normalizing" rate base components such as this to accurately reflect actual pricing and historical inventory levels. We believe it would be inappropriate to utilize the current inventory levels, which are clearly below the typical coal inventory levels due to reasons beyond the control of SCE&G. The current difficulties are well known and documented in the industry. Therefore, since the Company's adjustment is reasonably calculated to reflect the level of inventory investment the Company expects to have during the period these rates will be in effect, we approve the adjustment as proposed by both SCE&G and the Commission Staff.

xii. GridSouth RTO Costs (Company Pro Forma No. 20; Staff Pro Forma No. 23)

In this case, the Company seeks permission to begin amortization of its portion of the costs of the discontinued GridSouth RTO project. The Company is proposing to amortize this investment over 5 years, with a resulting annual amortization expense of $2,718,000. The Company also proposes to include in rate base $7,047,982, representing the average amount of investment which will be reflected on the Company's books during the requested five year amortization period. The total amount of the investment is $14,095,964. The parties to the Stipulation and Settlement have agreed that this proposed recovery is appropriate.

The testimony of Company witnesses Mr. Lorick and Dr. Wright recount a comprehensive history of the actions of FERC as it pertains to the creation and ultimate suspension of GridSouth regional transmission organization ("RTO"). (TR Vol. 1 at 118-122, 136-137, 194-201, 212-218 (Lorick); Vol. 5 at 1670-1699, 1705-1716 (Wright)). Other witnesses offered testimony in opposition to GridSouth recovery. (TR Vol. 3 at 971-976, 1000, 1007-1009, 1035-1036 (Watkins); Vol. 3 at 1167-1172, 1199-1200, 1207-1217 (Smith)). The Commission previously considered this issue in Docket 2002-223-E and concluded in Order No. 2003-38 that it was premature at that time to allow recovery of these costs. For purposes of this Order, the relevant facts, based on the foregoing testimony, are briefly summarized as follows.

On December 20, 1999, FERC issued its Order No. 2000 which required transmission owning utilities regulated by that agency to file a plan to join or form an RTO that would be operational by December 15, 2001, or provide an explanation as to why this could not be accomplished. FERC clearly signaled that companies not joining an RTO would be subject to substantial penalties, including possible loss of their ability to sell power at market rates in the wholesale markets. At the time of its Order 2000, FERC's approach to RTO's allowed for variation in their structure and function to meet local concerns and interests. As a result of this order, a number of utilities undertook complying efforts, among them, SCE&G, Duke Power, and Carolina Power & Light Company (CP&L), who joined efforts to form GridSouth RTO. Their objective, in addition to FERC compliance, was to develop an RTO focused on the customer and system needs of the Carolinas. The companies made their GridSouth filing with FERC on October 16, 2000 (94 F.E.R.C. ¶ 61,080), and FERC gave conditional approval for the RTO in March 2001. *Carolina Power & Light Co.,* 94 F.E.R.C. ¶ 61,273 (March 14, 2001). In this order, FERC approved GridSouth as a for-profit RTO, operating in North and South Carolina, which could eventually own its transmission assets. FERC also approved organizational documents under which the participating utilities would manage the formation of GridSouth. The "provisional approval" only indicated the fact that FERC was requiring that the original GridSouth documents be refiled with limited changes to reflect matters decided in the March 14, 2001 Order.

During the summer of 2001, a leadership change at FERC resulted in a dramatic change in that agency's RTO regulatory objectives. *See e.g. Regional Transmission Organizations, Order Initiating Mediation*, FERC ¶ 61,066 (2001), *n.b.* the concurring opinion of Commissioner Massey. As a consequence of this change in policy, the formation of GridSouth was no longer consistent with FERC regional transmission objectives, and, on June 18, 2002, the three participating utilities suspended this project. It is clear from the testimony of the Company witness, that all assets of GridSouth have now been disposed of and there will be no further utilization of this project for transmission or any other purpose.

The Commission finds that GridSouth represented a unique opportunity to support a more open electric market and, at the same time, create a locally based RTO, focused on the needs of customers and electric systems in North and South Carolina and answerable to the regulators of these states as well as FERC. In addition, the GridSouth expenses were incurred in specific response to FERC regulatory orders and directives. A utility must be able to reasonably rely on the directives of a regulatory agency to which it is subject and recover expenses incurred as a consequence of such reliance. FERC has specifically allowed the deferral of GridSouth costs in its accounting order for GridSouth, and the logic of its decision is clear. *See Duke Energy Corp.*, 94 F.E.R.C. ¶ 61,080 (January 25, 2001).

As a result, the Commission finds that the GridSouth expenses were directly related to compliance with mandates from Federal regulators with authority over important aspects of SCE&G operations related to the provision of electric service. Moreover, since transmission assets serve both wholesale and retail requirements on an integrated grid, recovery of these expenses is appropriate in this docket. In fact, as the evidence shows, the vast majority of SCE&G's service and revenue (approximately 94%) is retail. Its principal wholesale customers, comprising the additional 6%, are municipal electric systems in cities like Orangeburg, Winnsboro and McCormick. Under any circumstances, the majority of these GridSouth expenses are appropriately recoverable from retail customers.

It is the finding and conclusion of this Commission that the GridSouth project is in fact terminated and the assets related to it have been fully liquidated. The Company's decision to enter the GridSouth project, and the expenditures made in connection therewith, were reasonable and prudent. The decision to abandon the project was dictated by the FERC's decision that GridSouth no longer met its size and scope criteria for a regional RTO. The GridSouth expenses are properly recoverable in this docket as the Company and Staff propose.

xiii. Officer Compensation (Staff Pro Forma No. 32)

Among the expenses sought to be recovered by the Company in this proceeding is the full amount of compensation which the Company paid to its officers and employees during the test period. (Hearing Exhibit 22). The Company's compensation packages for its employees and officers are set annually based on surveys of market compensation in similarly situated companies with whom the Company, generally, must compete for employee and officer talent. (TR Vol. 2 at 693, 720-722, 733-734, Vol. 3 at 750, 802-803, 810-812, 815). The Company's compensation packages include base salaries, short-term incentives, and long-term incentives, designed to compensate employees and officers at the mid-point of the market for regional and industry standards. (*Id.*).

In the present case, the Staff initially recommended the disallowance of officer bonuses and pay increases as sharing mechanisms between rate payers and shareholders. Also, Consumer Advocate Witness, Glenn Watkins, proposed that there should be a 50/50 percent sharing of incentive compensation between the Company's customers and its shareholders based on the theory that officers and employees work, in some substantial measure, for the benefit of the shareholders, as well as the Company's customers. (TR Vol. 3 at 963-964, 997-998). The Company responded in support of full recovery in rates asserting that rate payers benefit from the proficiency and efficiency of officers and employees in that earnings reflect their performances. Moreover, a sharing of compensation expense would amount to a disallowance of a utility cost necessitating recovery from funds intended for other purposes. (*Id.*).

In Docket No. 95-1000-G, by Order No. 96-15, the Commission approved officer pay increases and officer incentive payments for inclusion in cost of service because they were considered to be part of a total “reasonable compensation package.” No party has challenged the appropriateness of the Company’s compensation packages. The Commission, therefore, finds that the compensation was paid during the test period; it is a recurring cost under the Company’s Compensation Plan; and the amounts paid are reasonable and prudent.

The foregoing notwithstanding, the Company has agreed to the Stipulation and Settlement reducing the revenue requirement for employee and officer compensation by $4,168,000.00, which is the portion of executive compensation attributable to SCE&G electric operations related to the salaries and incremental compensation paid to the five (5) company officials listed in SCANA’s Proxy Statement.

The Commission believes that the compromise is a reasonable and appropriate treatment of this issue, in light of the Stipulation and Settlement and the Company’s agreement, as part of an overall settlement, to the reduction in expenses in question. For purposes of this case, the Commission therefore approves the compromise position contained in the Stipulation and Settlement.

xiv. Insurance Expense (Navy Pro Forma No. 4)

During the test period, the Company's actual expense for property insurance was $3,325,963. The Navy, through its witness Mr. Smith, proposes to reduce SCE&G's property insurance expense by $154,810 to reflect trends he claims to have identified in this expense category due to reductions in the premiums under certain property insurance policies. (TR Vol. 4 at 1183). There is no evidence in the record, however, to indicate that SCE&G's expense level for property insurance was atypical during the test period. Nor can any clear trend be established because, during this one year, the premium costs for certain policies were reduced. Property insurance costs are notoriously volatile, and the evidence presented here establishes neither that the test year data is atypical or that there is a basis to identify a sustainable trend toward lower rates. The Commission declines to make the proposed adjustment.

2. Adjustments Resolved by Stipulation and Settlement

i. Selective Catalytic Reactor O&M (Company Pro Forma No. 6; Staff Pro Forma No. 6)

The Company has proposed a pro forma adjustment to increases O&M expenses for costs associated with the use of ammonia in three new Selective Catalytic Reactor units installed at Wateree and Williams Stations. (TR Vol. 2 at 693). This equipment has been required by State and Federal air quality regulation to reduce NOx emissions at those plants. The proposed adjustment is $1,523, 968.

The Commission Staff recalculated the cost of the ammonia based on actual ammonia expense during the summer of 2004 and produced a number that is $1,152,549, several hundred thousand dollars lower than the Company's proposed pro forma. (TR Vol. 4 at 1295). Consumer Advocate Witness Mr. Watkins recalculated the adjustment using more current costs and determined that it slightly understated the expected ammonia cost going forward (TR Vol. 3 at 962). The Company is willing to accept the Commission Staff's adjustment under the Stipulation and Settlement.

ii. Annualize Wages, Benefits and Payroll (Company Pro Forma No. 7; Staff Pro Forma No. 7)

No party has objected to the annualization of wages, benefits and payroll to reflect actual labor costs at the close of the test period. However, the Commission Staff, in its audit, calculated that Company's adjustment should be recalculated to reflect lower payroll taxes on those employees whose compensation exceeded the FICA base. The amount of the adjustment is $405,000. (TR Vol. 4 at 1295-96). The Company is willing to accept the Commission Staff's adjustment under the Stipulation and Settlement.

iii. Eliminate Employee Clubs Investment and Expense (Company Pro Forma No. 11; Staff Pro Forma No. 13)

In keeping with past Commission precedent, the Company removed from rate base ($3,118,924) O&M expense ($395,959), and depreciation expense ($142,003) items related to employee recreational clubs. (TR Vol. 2 at 695). In conducting its audit, the Staff identified found two projects in the category of Construction Work Not Classified that were related to these clubs. The resulting adjustment would increase the pro forma reduction in rate base to $3,809,000. (TR Vol. 4 at 1297-980). The Company is willing to accept the Commission Staff's adjustment under the Stipulation and Settlement.

iv. Adjust Working Cash (Company Pro Forma No. 21; Staff Pro Forma No. 21)

The Company and the Staff differ on how to properly compute adjustments to working cash. The Company has consistently proposed applying the one-eighth formula to all pro forma expense adjustments. (TR Vol. 2 at 702). The Company's position is that there are cash needs associated with pro forma expenses which should be recognized in the working cash calculation. (TR Vol. 2 at 717-18). The Staff has traditionally applied the formula to adjustments only where the adjustments were corrections to mistakes in per books expense items, and not annualizations, levelizations, out-of-period adjustments, etc. (TR Vol. 4 at 1327). The Company's proposed working cash adjustment is $4,699,000. The Company is willing to accept the Commission Staff's position and not make this adjustment under the Stipulation and Settlement.

v. Non-Allowables (Staff Pro Forma No. 26)

In its audit, the Commission Staff identified miscellaneous test year expense items amounting to $503,406 that it deemed to be non-allowables. (TR Vol. 4 at 1305). The Company is willing to accept the Commission Staff's adjustment under the Stipulation and Settlement.

vi. Interest on Customer Deposits (Staff Pro Forma No. 27)

The Staff has proposed a pro forma adjustment to test year rate base to reflect the accrued interest on customer deposits. The amount of the adjustment is $1,582,143. (TR Vol. 4 at 1305). The Company objects to the basis for this adjustment, testifying that accrued interest overstates the required adjustment, since it does not reflect the off-setting amount paid to customers during the period. (TR Vol. 2 at 720). The outstanding balance of accrued interest at the close of the test year is the number that reflects both accruals and payments according the Company. (TR Vol. 2 at 720). As of September 30, 2004, that amount is only $423,834. (TR Vol. 2 at 720). The Company is willing to accept the Commission Staff's adjustment under the Stipulation and Settlement.

vii. Genco Working Capital (Staff Pro Forma No. 30)

The Staff proposes to remove the cash working capital component associated with payments by SCE&G to GENCO, the affiliated generation company that owns Williams Station. (TR Vol. 4 at 1306). The Company is willing to accept this adjustment as part of the Stipulation and Settlement.

viii. Test Year Moving Expenses (Staff Pro Forma No. 31)

Pursuant to the Stipulation and Settlement, the Staff has agreed not to seek an adjustment related to test year moving expenses. The Staff's position in this regard is based on the assertion that actual test year moving expenses should be disallowed in favor of a five year average. (TR Vol. 4 at 1306). The Company believes that its actual test year experience is an appropriate reflection of current costs and expenses for this item and the Stipulation and Settlement reflects this position.

ix. Litigation Expenses (Staff Pro Forma No. 33)

The Staff proposes to remove from test year litigation expenses $1,023,675 in actual test year expenditures that it believes are not known and measurable. (TR Vol. 4 at 1306). The Company is willing to accept the Commission Staff's adjustment as part of the Stipulation and Settlement.

x. Legal Expenses Related to Franchise Fee Billing Matter (Staff Pro Forma No. 34)

The Staff proposes to remove from test year litigation expenses $87,884 of actual legal expenses that were associated with disputes concerning the billing of franchise fees to customers. (TR Vol. 4 at 1306).). The Company contests the Staff's adjustment but is willing to accept the it as part of the Stipulation and Settlement.

3. Uncontested Adjustments

The following pro forma adjustments are uncontested adjustments proposed by the Company or the Staff to eliminate non-recurring items, to update or annualize test year information, or to correct errors in the Application and supporting documentation. The Commission finds these adjustments to be appropriate to create test year data that properly reflects the Company's cost of providing service to its customers. It adopts these adjustments for the reasons set forth in the testimony of the witnesses that sponsored them.

i. Eliminate Short Term Capacity Purchases (Company Pro Forma No. 3)
ii. Williams Stations Environmental Cost Update (Company Pro Forma No. 4)
iii. Pension and Health Care Related Adjustments – Pension Income (Company Pro Forma No. 8)
iv. Pension and Health Care Related Adjustments – OPEBS (Company Pro Forma No. 8, Staff Pro Forma No. 9)
v. Eliminate Demand Side Management Costs (Company Pro Forma No. 10)
vi. Recognize Property Retirements (Company Pro Forma No. 12)
vii. Recognize Property Additions – Additional Plant Closings, Additional Retirements (Company Pro Forma No. 13)
viii. Annualize Current Depreciation Rates (Company Pro Forma No. 14)
ix. Adjust Property Taxes (Company Pro Forma No. 16)
x. Tax Effect of Annualized Interest (Company Pro Forma No. 21; Staff Pro Forma No. 25)
xi. Update CWIP to May 31, 2004 (Staff Pro Forma No. 15)
xii. Unclaimed Funds (Staff Pro Forma No. 28)
xiii. Per Book Income Tax Error (Staff Pro Forma No. 35)

The Commission further finds that, in calculating final rates under this Order, these and all other pro forma adjustments should be revised to reflect the Commission's specific rulings contained elsewhere in this Order and to reflect the other corrections to these adjustments proposed by the Staff and not contested by the Applicant or resolved in the Stipulation and Settlement.

The Commission holds that all other accounting and *pro forma* adjustments proposed by the Commission Staff, and not objected to by other parties, are approved. Further, all other adjustments proposed by other parties, which are not specifically addressed herein, have been considered by the Commission and are denied.

D. FIXED PIPELINE CAPACITY CHANGES IN BASE RATES (FINDING OF FACT NO. 11)

Pursuant to the Commission ruling in Docket No. 2004-02-E, these fixed pipeline charges are presently included in the Company's annual fuel forecast and are currently being recovered through the fuel factor approved in that docket. (TR Vol. 2. at 714). If adopted, this adjustment would reduce the fuel factor approved in Docket No. 2004-02-E by $0.00057/kwh. To ensure that there is no over or under recovery of these charges in future years, the Company has proposed to flow any positive or negative difference between the amount included in base rates and the actual charges for the fixed capacity charges through the fuel adjustment clause. (TR Vol. 2 at 714-15). The treatment proposed here is identical to the treatment of the fixed gas pipeline charges associated with the repowered gas fired Urquhart Units which the Commission approved in Order No. 2003-38.

Consistent with its ruling in Order No. 2003-38, the Commission finds that it is appropriate to treat these fixed pipeline capacity charges, which do not vary with consumption of natural gas by the plant, as fixed costs recovered through base rates. None of the parties have objected to this treatment of the costs as a matter of principle. However, Witness Watkins, on behalf of the Consumer Advocate, has challenged the adjustment arguing that that "[b]ecause the requested amount is being contested in a separate docket, the Commission should not include Jasper's fixed gas supply costs in base rates until that matter is resolved." (TR. Vol. 3 at 968).

The Commission is in fact reviewing these contracts further, but has allowed the Company to recover the costs in question through the fuel clause on an on-going basis. The Commission finds that placing the retail portion of the $15.3 million fixed charges, which is $10,922,000, in base rates will in no way interfere with the Commission's ability to adjust the amount properly recoverable from customers at any point in the future.

The Company's proposed adjustment involves crediting to the fuel clause calculation one-twelfth of the $10.9 million fixed charge each month. (TR Vol. 2 at 714-15; Vol. 3 at 816-17). This credit will not vary while the rates set in this proceeding are in effect. If in another docket the Commission allows the Company to recover less than $10.9 million per year for Jasper pipeline capacity charges, then the credit ordered in this proceeding will exceed the actual costs allowable in the fuel clause and the difference will flow through to customers as a net credit to fuel costs. (TR Vol. 3 at 816-17). In short, customers will receive the full amount of any future adjustment in these charges immediately upon any such adjustment being ordered. (TR Vol. 3 at 816-17).

Accordingly, the Commission determines that the rate adjustment as proposed by the Company would not result in any over recovery of these costs and there is no reason to delay shifting these costs into base rates.

E. REQUEST FOR PROPOSAL (RFP) PROCESS (FINDING OF FACT NO. 22)

Columbia Energy has recommended that "the Commission adopt, or at least initiate, an RFP process," or conduct a rule-making process to consider establishing an RFP process. (TR Vol. 3 at 1102; TR Vol. 4 at 1148). Its witness, Dr. Dismukes, advocates that there are a number of benefits to be derived from such a process: an additional means of evaluating a utilities resource decision, costs, market alternatives, and similar considerations. He believes that such a process would assist in insuring that least cost resources are pursued. (TR Vol. 3 at 1102). An RFP process would necessarily have to be sufficiently sophisticated to incorporate details such as the financial stability of proposing companies. (TR Vol. 4 at 1145-1146).

In responding to Columbia Energy's proposal, Company witness, Mr. Lorick, stated, "SCE&G is not opposed to using an RFP process for purchased power when that process is consistent with the overall needs of the Company and is necessary to insure that the Company has information, not otherwise available, needed to make sound business decisions." (TR Vol. 5 at 1518). Mr. Lorick pointed out that the Company utilized an RFP process in the recent past, notably in connection with its Urquhart Repowering Project, which information carried over to its Jasper Project. (*Id.*). However, Mr. Lorick expressed concerns that reliance on a long term purchased power agreement, in lieu of owned generation, presented reliability issues for the Company and its customers, since the delivery of such power depended directly on the ongoing viability of the supplying company. (*Id.* at 1519). Because his company is ultimately responsible for providing power to its customers, Mr. Lorick does not believe that the Company's ability to make what it determines to be reasonable, prudent, and sound business decisions should be limited by a restrictive RFP process. The Company should continue to be required to demonstrate the prudence of its decisions to the Commission – with or without an RFP – as is presently the case. (*Id.* at 1520).

The Commission believes that the utilization of an RFP process should provide information helpful to a utility in making reasoned decisions regarding how its generation requirements will be met. However, the Commission also shares the Company's concern that a decision-making process which is too restrictive would be detrimental to the utility. The Commission cannot hold accountable the utilities it regulates if it imposes on them a decision-making process which limits the exercise of their business judgment.

For these reasons, the Commission declines to hold a rule-making proceeding regarding the development of an RFP process, but reminds SCE&G and the other utilities it regulates that it will expect applications for added generation capacity to reflect a comprehensive consideration of available alternatives.

F. REQUEST TO ORDER A LEAD-LAG STUDY FOR THE NEXT RATE PROCEEDING (FINDING OF FACT NO. 12)

In 1989, the Commission reviewed the result of a lead-lag study that it had ordered SCE&G to perform along with all other electric and gas utilities under its jurisdiction. In that proceeding, the Commission found that the one-eighth formula provided comparable results to a properly conducted lead-lag study and that "the expense and effort to prepare such a [lead-lag] study did not justify its utilization." Order No. 89-588 at 39.

The Commission addressed the issue again in Order No. 93-465 (pp. 36-37), where it ruled as follows:

> [T]he one eighth formula is a proper means to determine cash working capital. One reason is practicality. The lead-lag study is extremely complex and expensive. A utility company, like SCE&G, generates millions of bills for services each year and pays thousands of bills from suppliers. If the Commission were to order lead-lag studies, SCE&G's customers would ultimately pay the cost of them. Moreover, the outcome of the studies is very much dependent on the assumptions used in labeling and tracking expenditures. . . .[U]tility companies are uniquely well-suited for application of a standard formula for cash-working capital purposes.

Order No. 93-465 at 36-37; *See also* Order No. 2003-38 at 34-36 (reaffirming this position.).

No party has objected to the use of the one-eighth formula in this proceeding. The Consumer Advocate witness, Watkins, however has requested that the Commission order the Company to undertake a lead-lag study for determining cash working capital in its next rate proceeding. (TR Vol.3 at 976-977). In response, the expert accounting witness for the Company, Ms. Walker, testified that "[t]he justifications for not conducting such [lead-lag] studies are equally applicable today as they were in past cases – they are inconclusive, unnecessary and unjustifiably expensive ." (TR Vol. 2 at 716-717).

The record here does not contain any evidence indicating that the conclusions reached in the prior orders no longer apply. The record provides the Commission with no reliable, credible or probative evidence on which to conclude that new lead-lag studies would, in fact, produce benefits that out weight the simplicity, clarity and efficiency gained by continuing to rely on the one-eighth formula. The Commission declines to order such a study and reaffirms its ruling in Order No. 93-465.

G. EVIDENCE AND CONCLUSIONS REGARDING YEAR END ORIGINAL COST RATE BASE (FINDING OF FACT NO. 31)

Pursuant to *S.C. Code Ann.* § 58-27-180 (1976), the Commission has the authority after hearing to "ascertain and fix" the value of the property of an electric utility. In the context of a ratemaking proceeding, such authority is exercised in the determination of the electric utility's rate base.

For ratemaking purposes, the rate base is the total net value of the electric utility's tangible and intangible capital or property value on which the utility is entitled to earn a fair and reasonable rate of return. The rate base, as allocated or assigned directly to SCE&G's retail electric operations, is composed of the value of SCE&G's property, used and useful in providing retail electric service to the public, plus net nuclear fuel, construction work in progress, materials and supplies, and allowance for cash working capital. The rate base computation incorporates reductions for the reserve for depreciation and amortization, accumulated deferred income tax and customer deposits. In accordance with its standard practice, the Accounting Department of the Commission Staff conducted an audit and examination of SCE&G's books, and verified all account balances from SCE&G's General Ledger, including rate base items, with plant additions and retirements. (Hearing Exhibit 22, 23, 34). On the basis of this audit, pertinent hearing exhibits, and testimony contained in the record of the hearing, the Commission can determine and find proper balances for the components of SCE&G's rate base, as well as the propriety of related accounting adjustments.

For ratemaking purposes, the Commission has traditionally determined the appropriate rate base at the end of the test period. This Commission's practice of determining a utility's rate base on a "year end" basis serves to enhance the timeliness of the effect of such action, and preserves the reliance on historic and verifiable accounts without resort to speculative or projected figures. Consequently, the Commission finds it most reasonable to continue to adhere to this regulatory practice and evaluate the issues of this proceeding using a rate base for SCE&G's retail electric operations as of March 31, 2004.

When the rate base has been established, SCE&G's total operating income for return is applied to the rate base to determine what adjustments, if any, to the present rate structure are necessary to generate earnings sufficient to produce a fair rate of return. The rate base should reflect the actual investment made by investors in SCE&G's property and the value upon which stockholders will receive a return on their investment.

The Commission hereby adopts the following as the Company's rate base:

TABLE B
ORIGINAL COST RATE BASE
RETAIL ELECTRIC
MARCH 31, 2004
(000'S)

	Stipulation	Application
Gross Plant in Service	5,738,967	5,739,630
Accumulated Depreciation	1,792,637	1,792,817
Net Plant	3,946,330	3,946,813
CWIP	123,201	123,201
Accumulated Deferred Income Taxes	(477,114)	(477,114)
Materials & Supplies Inventory	130,280	139,666
Total Working Capital	(11,328)	2,089
Deferred Debits/Credits	(85,064)	(84,966)
Total Original Cost Rate Base	3,626,305	3,649,689

H. EVIDENCE AND CONCLUSIONS REGARDING COST OF CAPITAL (FINDINGS OF FACT NOS. 34)

1. COST OF EQUITY

a) LEGAL STANDARDS

In setting rates, the Commission must determine a fair rate of return that the utility should be allowed the opportunity to earn after recovery of the expenses of utility operations. The legal standards applicable to this determination are set forth in *Federal Power Comm'n. v. Hope Natural Gas Company*, 320 U.S. 591, 602-03 (1944); and *Bluefield Water Works & Improvement Co. v. Public Service Comm'n. of West Virginia*, 262 U.S. 679, 692-93 (1923). These standards were adopted by the South Carolina Supreme Court in *Southern Bell Teleph. and Telegr. Co. v. South Carolina Pub. Serv. Comm'n*, 270 S.C. 590, 595-97; 244 S.E. 2d. 278, 281 (S.C. 1978).

Specifically, *Bluefield* holds that:

> What annual rate will constitute just compensation depends upon many circumstances, and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting the

> opportunities for investment, the money market and business conditions generally.

262 U.S. at 692-73, as quoted in *Southern Bell,* 240 S.C. at 595-96; 244 S.E. 2d. at 281. In addition, these cases establish that the process of determining rates of return requires the exercise of informed judgment by the Commission. As the South Carolina Supreme Court has held:

> "the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover, involves the making of 'pragmatic adjustments'. . . . Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. . . . The ratemaking process under the Act, <u>i.e</u>., the fixing of 'just and reasonable' rates, involves the balancing of the investor and the consumer interests."

Southern Bell 244 S.E. 2d. at 281 (quoting *Federal Power Comm'n.* 320 U.S. at 602-03). This is in keeping with the general rule that "[r]atemaking is not an exact science, but a legislative function involving many questions of judgment and discretion." *Parker v. South Carolina Pub. Service Comm'n.*, 200 S.C. 310, 312, 313 S.E.2d 290, 291 (S.C. 1984).

These principles have been employed by the Commission and the Courts of this State consistently since their adoption in 1978. They continue to provide the appropriate standards to guide the Commission's determination of rates of return in proceedings such as this one. From these authorities, the Commission derives the following specific points to guide its evaluation of the evidence in this case:

1) The rate of return should be sufficient to allow SCE&G the opportunity to earn equal to firms facing similar risks;

2) The rate of return should be adequate to assure investors of the financial soundness of the utility and support the utility's credit and ability to raise capital needed for on-going utility operations at reasonable cost;
3) The rate of return should be determined with due regard for the present business and capital market conditions facing the utility;
4) The rate of return is not formula-based but requires an informed expert judgment by the Commission balancing the interests of shareholders and customers.

Finally, the Commission notes that "[t]he determination of a fair rate of return must be documented fully in its findings of fact and based exclusively on reliable, probative, and substantial evidence on the whole record*." Porter v. South Carolina Pub. Serv. Comm'n.,* 332 S.C. 93, 98, 504 S.E.2d 320, 323 (S.C. 1998) [citing S.C. Code Ann. § 58-5-240 (Supp. 1997); *accord* S.C. Ann. § 58-27-870(G) (Supp. 2004)].

b) OVERVIEW OF THE TESTIMONY

The starting point for the determination of SCE&G's cost of capital is a review of the testimony of the witnesses who testified concerning an appropriate Return on Equity ("ROE") for SCE&G Company. In all, seven witnesses testified as to the appropriate cost of capital for SCE&G. Those witnesses were

- Burton G. Malkiel, Ph.D., the Chemical Bank Chairman's Professor of Economics at Princeton University who testified on behalf of SCE&G. Dr. Malkiel is former Chairman of the Economics Department of Princeton, former director of the Financial Research Center at Princeton, former Dean of the Yale Business School, and a former member of the President's Council of

Economic Advisors. He is a member of the Board of Directors and Chairman of the Investment Committee of Prudential Securities Company and is a Member of the Board of Directors of the Vanguard Group of Investment Companies. (The latter companies have a combined investment portfolio in excess of $1 trillion.) Dr. Malkiel has published extensively on finance issues both in the academic and popular press and is an internationally recognized expert on corporate finance issues;

- Julie M. Cannell, President of J. M. Cannell Inc., who testified on behalf of SCE&G. Mrs. Cannell is a consultant specializing in the investment community as to its attitudes and perceptions related to the electric industry in the United States. Mrs. Cannell holds an MBA in finance from Columbia University and has served as a security analyst specializing in the electric utility industry, as portfolio manager for a major utility equity mutual fund, and as co-director of Equity Research Department for the investment company Lord Abbett.
- Mr. Thomas R. Osborne, Managing Director in the Global Power Group of UBS Investment Bank, who testified on behalf of SCE&G. Mr. Osborne identified the group of comparable companies on which Dr. Malkiel based his analysis and also testified as to market conditions and other financial matters.
- Mr. Kevin Marsh, Chief Financial Officer of SCANA Corporation and SCE&G.
- Mr. Labros E. Pilalis, Esq., research analyst with the consulting firm of Rhoads & Sinon Group LLC, who testified on behalf of the Staff of the Public

Service Commission of South Carolina. Mr. Pilalis holds a Masters of Public Affairs (Public Administration) degree and a Juris Doctor degree from Indiana University;

- Mr. Glenn Watkins, Senior Economist with Technical Associates, Inc., who testified on behalf of the Department of Consumer Affairs. Mr. Watkins holds a Masters of Business Administration from Virginia Commonwealth University; and
- Mr. Kevin O'Donnell, President of Nova Energy Consultants, Inc. who testified on behalf of the South Carolina Energy Users Committee. Mr. O'Donnell holds a Masters in Business Administration, Finance, from Florida State University.

Of the seven witnesses who testified concerning ROE, only one, Mr. Watkins, objected to the ROE proposed in the Stipulation and Settlement, *i.e.* an ROE range of 10.4% to 11.4% with rates set at the midpoint of 10.9%.

Four witnesses, Dr. Malkiel, Mr. Pilalis, Mr. Watkins, and Mr. O'Donnell, based their analyses on numerical models. The other three ROE witnesses, as well as Dr. Malkiel and Mr. O'Donnell, based their conclusions both on numerical modeling and on their understanding of current market condition and investor expectations.

In considering an appropriate ROE for SCE&G, the Commission will review the methodology and conclusions of the witnesses who employed numerical models to calculate an ROE for SCE&G. The Commission next will consider the other evidence related to market conditions and investor expectations at this time. Finally, the

Commission will review evidence in support of the ROE proposed in the Stipulation of Settlement.

c. NUMERICAL MODELS

Of the three witnesses who provided numerical ROE calculations, all provided at least one calculation based on the Discounted Cash Flow ("DCF") model. In addition, Mr. Pilalis and Mr. Watkins, also performed analyses using the Capital Assets Pricing Methodology, or "CAPM." The first step in both of these analyses involve selecting a comparable group of companies to SCE&G on which the models can be run.

i. Comparable Companies

The need for selecting a group of comparable companies stems from the fact that SCE&G is a wholly owned subsidiary of SCANA Corporation and SCE&G's shares are not publicly traded. Accordingly, to make a numerical calculation of the cost of capital for SCE&G it is necessary to analyze a group of proxy or "comparable" companies. (TR Vol. 2 at 460-61).

The analyses conducted by Dr. Malkiel, Mr. Pilalis, and Mr. Watkins were all based on a group of six comparable companies selected by Mr. Thomas Osborne. Mr. Osborne based his selection of a comparable companies on his 17 years experience in the investment banking industry specializing in electric utilities. (TR Vol. 2 at 358-59). In identifying comparable companies, Mr. Osborne sought to select a group of companies with a risk profile that in aggregate was similar to SCE&G's based on market capitalization; capital structure; financial leverage; credit ratings; Standard & Poor's business profile score; proportion of regulated and unregulated operations and investment; and profitability. (TR Vol. 2 at 361-62).

The group of comparable companies Mr. Osborne selected was based on the same group used in SCE&G's last retail electric rate case. (TR Vol. 2 at 369). However, as Mr. Osborne testified, out of this group of seven companies, three companies have experienced substantial degradation in their financial standings and business profiles since the last proceeding. (TR Vol. 2 at 369-72). Accordingly, Mr. Osborne excluded them from the group. He replaced these three companies with two additional companies which he believes have similar investment risk profiles and characteristics to SCE&G. (TR Vol. 2 at 372-73). In his testimony, Mr. Osborne has provided a detailed justification for the selection of each these companies as comparable companies for SCE&G. (TR Vol. 2 at 372-73). No party has challenged Mr. Osborne's comparable group.

Mr. O'Donnell is the only witness who used a different group of comparable companies than those proposed by Mr. Osborne. He selected a much larger group of 25 companies. As Mr. Osborne testified, Mr. O'Donnell's group includes companies with very different financial and business profiles than SCE&G. Some of these companies have market capitalization that is many times greater than SCE&G's; some of these companies have credit ratings that are substantially different from SCE&G's; and some of these companies have risk and business profiles that are substantially different from SCE&G's. (TR Vol. 4 at 1229). The Commission notes that Mr. O'Donnell reaches the same ultimate ROE recommendation using his comparable group (10.0% before flotation adjustment), as does Dr. Malkiel using the Osborne Group. (TR Vol. 4 at 1235).

The Commission finds that Mr. Osborne's testimony concerning his selection of comparable companies is reliable and probative. The Commission notes that Mr.

Osborne is an investment banker with 17 years experience in valuing utility stocks and bonds. He has direct experience concerning how the investment community selects, analyzes and evaluates comparable companies to establish equity values for utilities. The Commission finds that Mr. Osborne has in fact selected a group of companies that constitutes a reliable proxy for SCE&G. The Commission specifically finds that in selecting this group, Mr. Osborne has appropriately balanced size, proportion of regulated and unregulated assets and income, credit ratings, risk factors, and other financial and operational indicators. As a result, the group as a whole fairly reflects the market's assessment of businesses with risks comparable to SCE&G. The Commission finds that the Osborne comparable group most closely matches the relevant risk and financial parameters for SCE&G and so is the preferable group of comparables to use for this proceeding.

ii. Capital Assets Pricing Model (CAPM)

Using Mr. Osborne's comparable companies, Mr. Pilalis and Mr. Watkins conducted an numerical analysis of SCE&G's required ROE using the Capital Assets Pricing Model, or "CAPM" model. These CAPM analyses produced expected rates of return of 10.74% and 10.2% respectively when applied to the SCE&G comparable companies identified by Mr. Osborne. (TR Vol. 5 at 1488; Vol. 3 at 938).

In SCE&G's last electric rate order, the Commission expressed concerns about the reliability of the CAPM methodology. Order No. 2003-38 at 56. The Commission's findings were based on testimony from Dr. Malkiel concerning serious questions that have arisen in the financial community about the reliability of the CAPM model. Order No. 2003-38 at 56. In this proceeding, Dr. Malkiel reaffirmed his concerns about the

CAPM model and provided additional data demonstrating that, during recent years companies, with lower volatilities in their share prices, known as "betas," have experienced higher returns on equity than more volatile higher beta companies. This is exactly the opposite results of what the CAPM theory would predict. (TR Vol. 2 at 492). Dr. Malkiel concluded that "CAPM estimates tend to understate the required rate of return for low beta stocks," such as electric utilities. (TR Vol. 2 at 491). The Commission again finds Dr. Malkiel's testimony to be credible and probative. It confirms the Commission's conclusion in Order No. 2003-38 that CAPM is not a favored methodology for analyzing market expectations of ROE for utility companies.

In addition to his general concerns about CAPM as an analytical tool, Dr. Malkiel noted in his rebuttal testimony that in applying CAPM, Mr. Watkins had miscalculated the risk premium for SCE&G by relying on the historical risk premium of companies much larger and hence substantially less risky that SCE&G. (TR Vol. 2 at 492). Mr. Pilalis, by contrast, relied on a risk premium calculation that averaged the risk premiums for large and small cap companies, thus more accurately reflecting the risk premium associated with a mid-cap company of the size of SCE&G. (TR Vol. 5 at 1487).

Accordingly, based on the Commission's general concerns about the nature of CAPM as an analytical tool, the Commission will not place substantial weight on the CAPM analysis. However, the Commission notes that the analysis of Mr. Pilalis, which employed a reasonable estimate of a risk premium for SCANA, is the more appropriate and methodologically sound CAPM analysis and would support ROE in the range proposed in the Stipulation and Settlement.

iii. Discounted Cash Flow Model (DCF)

The DCF model ("DCF" or "Gordon Model") measures investors' return requirements by correlating a company's stock price with the present value of its anticipated earning stream, and through this analysis, determines the rate of return assumptions embedded in that relationship. (TR Vol. 2 at 456-460). Dr. Malkiel, Mr. Pilalis, Mr. O'Donnell and Mr. Watkins all used the DCF model to analyze SCE&G's cost of equity capital.

Dr. Malkiel employed a single DCF calculation based on the inputs concerning future earnings and dividend growth rates which both he and the academic finance community and the investment community have found to be most reasonable and accurate. (TR Vol. 2 at 490). Dr. Malkiel testified that his teaching, his own research, and his experience as a director of several financial corporations demonstrated that forecasts of future growth rates as provided by security analysis are the most accurate indicators of the growth rates and are the indicators which investors in fact use to judge the appropriate market prices for stocks. (TR Vol. 2 at 490). Accordingly, Dr. Malkiel based his DCF analyses exclusively on these forecast growth rates. His calculation showed a range of returns based on the DCF model of between 11.9% and 9.0% for the comparable companies before flotation adjustment. (TR Vol. 2 at 463). He computed a mean DCF-based ROE for the comparable group of 10.0%. (TR Vol. 2 at 463).

As a check on this result, Dr. Malkiel also computed the expected returns for a group of much larger utility and telecommunication companies. (TR Vol. 2 at 463-64). Because of their greater size and the greater diversity of their markets, these companies have lower risk profiles than SCE&G and would be expected to have lower ROEs as indicated by a DCF analysis. (TR Vol. 2 at 463-65). In fact, the analysis of these less risky utility and telecommunication companies produced mean DCF-based ROEs of 9.4% and 9.5% respectively before flotation adjustment. (TR Vol. 2 at 464). This result confirmed the reasonableness of the DCF-based calculation of 10.0% for the SCE&G comparable companies. (TR Vol. 2 at 465).

Mr. Pilalis used a DCF model that was generally similar to Dr. Malkiel's. However, Mr. Pilalis used different sources, vintages, and approaches to computing model inputs such as dividend yield, dividend growth rates and long-term earnings per share growth rates. (TR Vol. 5 at 1480-1482). Applied to the Osborne comparables, Mr. Pilalis's computations resulted in DCF-based ROE estimates between 8.5% and 11.46% before flotation costs. (TR Vol. 5 at 1484). He computed a mean ROE for the comparable group of 9.35%. Mr. Pilalis then computed a DCF rate for SCANA of 9.07% and averaged this rate with the comparable group to produce a recommended DCF based ROE of 9.21%. (TR Vol. 5 at 1484).

Mr. O'Donnell used the 25 company comparable group in making his DCF calculation. He analyzed historical as well as forecasted growth rates in earnings, dividends, and book value per share. Using these methodologies, his results were in a range of 8.5% to 9.5%, for a Comparable Group and range of 8.5% to 10.0% for SCANA. Based on these DCF results, Mr. O'Donnell recommended a ROE for SCE&G of 10.0%. (TR Vol. 4 at 1235; Hearing Exhibit 33).

Mr. Watkins used a combination and averaging of several growth rates in computing a DCF-based return for the comparable companies. (Hearing Exhibit 23). The averaging in almost all cases resulted in a lower estimated growth rate than the growth rate in earning per share as predicted by security analysts. (Hearing Exhibit 23). In addition, Mr. Watkins used assumptions concerning the timing of dividend payments and the dividend growth in the current year that, as Dr. Malkiel testified, are contrary to accepted practice in the financial community. (TR Vol. 2 at 489-90). Using DCF analyses based on historical earning growth, Mr. Watkins' computations resulted in DCF-based return estimates between 8.3% and 10.0% for the comparable companies with a mean return of 8.8%. (Hearing Exhibit 23). Using DCF analyses based on projected growth rates, Mr. Watkins' computations resulted in DCF-based return estimates between 8.0% and 11.2% for the comparable companies with a mean return of 9.1%. (Hearing Exhibit 23). A review of Mr. Watkins's analysis indicates that he selected forecasted growth rates for use in his calculation that were substantially lower than those presented by Dr. Malkiel. (Hearing Exhibit 23).

Conclusions Concerning the DCF Analysis –The Commission finds the DCF analysis presented by Dr. Malkiel to be the most reliable and probative of the various numerical ROE analyses presented by witnesses in this proceeding. Dr. Malkiel's academic credentials and extensive practical experience in the investment community clearly make him a very credible witness concerning ROE calculations. Dr. Malkiel's DCF analysis relies on a straightforward and verifiable calculation of expected earnings growth, as publicly reported by financial analysts, and applies these inputs on a company by company basis. As Dr. Malkiel testified, the conclusion of this research and teaching, and of his experience in the investing community, is that his approach represents the most accurate and accepted method for applying the DCF model to estimate the appropriate market price of securities.

The Commission also finds that Dr. Malkiel appropriately tested the results of his analysis by conducting a similar DCF analysis of two groups of larger, more diverse and less risky corporations. These tests produced results which fully substantiate the approach Dr. Malkiel used in conducting his DCF analysis of the Mr. Osborne's comparable companies. The Commission finds that the companies employed by Dr. Malkiel for this test of his result in fact have risk profiles substantially lower than those of SCE&G and the comparable group for the reasons stated in Dr. Malkiel's direct and rebuttal testimony. (TR Vol. 2 at 463-65). The Commission finds that this analysis of less risky companies provides reliable and probative check on the reasonableness of Dr. Malkiel's DCF analysis of the comparable company group.

The Commission finds further that the DCF analyses of Mr. Watkins produced indicated ROEs for the comparable companies which were substantially lower than the rates Dr. Malkiel computed for the lower risk groups of companies. The Commission finds that this conflict between Mr. Watkin's results, and the results of Dr. Malkiel's test of his results against lower risk companies is significant. It provides reliable and probative evidence that Mr. Watkins DCF analysis has underestimated the required ROE for SCE&G and the comparable companies.

Accordingly, the Commission determines that the reliable, probative and substantial evidence on the record of this case supports the conclusion that a properly conducted DCF model of SCANA and its comparable companies, before flotation costs and other adjustments, would produce an ROE in the range testified to by Dr. Malkiel of between 11.9% and 9.0% with a mean of 10.0%.

d. TESTIMONY REGARDING MARKET CONDITIONS AND THE STIPULATION AND SETTLEMENT

As the establishment of an appropriate rate of return requires "the exercise of a fair and enlightened judgment, having regard to all relevant facts." *Southern Bell Tel. & Tel. Co. v. Pub. Serv. Comm'n. of South Carolina*, 270 S.C. 590, 59, 244 S.E.2d 278, 281 (1978) (quoting *Bluefield Water Works & Improvement v. Pub. Serv. Comm'n. of West* Virginiak, 262 V.S. 679, 692-93 (1923). The Commission is expressly authorized to take into account investors' expectation, and current market conditions in exercising its judgment. *Id.* quoting, *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602-03 (1944).

<u>Current Market Conditions</u> --In this proceeding, Dr. Malkiel, Mrs. Cannell, and Mr. Marsh all testified to the fact that present market conditions are characterized by interest rates that are at historically low levels. (TR Vol. 1 at 283-84; Vol. 2 at 468-69; 567). These low interest rates depress the results of DCF analyses, especially for utility companies whose stock prices are very much interest rate sensitive and move inversely to interest rate changes. (TR Vol. 2 at 366, 555).

Not only are current interest rates extremely low by historical measures, the consensus of market analysts is that they are unsustainable. Dr. Malkiel and others presented reliable and probative evidence that interest rate increases are to be expected in future months as the Federal Reserve Bank moves interest rates to more sustainable and historical levels. (TR Vol. 1 at 283-84; Vol. 2 at 468-69; 567).

As Dr. Malkiel has testified, investors have provided SCE&G with the capital needed to complete projects such as the Jasper Generating station at times when rates of return were significantly higher. (TR Vol. 2 at 469). The Commission finds that SCE&G has in fact raised significant amounts of capital in recent years based on investors' expectation that SCE&G would earn a return on equity reasonably commensurate with its historical ROE ranges. As Dr. Malkiel has testified, investors have committed funds to SCE&G with an expectation of returns that are substantially different from what current DCF analyses would indicate.

Based on these considerations, Dr. Malkiel determined that there were "good reasons for the Commission to maintain the 12.45% ROE that it allowed in 2002." (TR Vol. 2 at 469). Dr. Malkiel testified that the 12.45% ROE established in 2002 could appropriately form the upper band on a range of reasonable ROEs for the Company. (TR Vol. 2 at 471). Combining this approach with the results of his DCF analysis, Dr. Malkiel testified that, in light of the unusual economic conditions at present, a reasonable range of ROE's for SCE&G before flotation adjustment would be a high of 12.45% and a low of 10.0%. (TR Vol. 2 at 471). The mid-point of that range would be 11.2%.

Furthermore, as both Mrs. Cannell and Mr. Marsh testified, a key factor in SCE&G's ability to access capital on national markets at reasonable rates has been investors' perception that the Company has received stable, balanced and consistent regulation over many years. (TR Vol. 1 at 273-75; Vol. 2 at 569). In his testimony, Mr. Marsh quantified some of the benefits that customers had received from investors' perception of stable and balanced regulation. These benefits include SCE&G's ability to maintain favorable Single-A credit ratings and SCE&G's ability to issue equity at prices that reduce dilution of earnings and the amount of future dividends that must be paid out per unit of equity capital raised. (TR Vol. 1 at 279-80; Vol. 2 at 569). Mr. Marsh testified that absent the Single-A bond rating, customers would have been required to pay an additional $41 million in interest related to SCE&G's 2003-2004 borrowings to finance completion of the Jasper Plant and other near term capital projects. (TR Vol. 1 at 279-80). In addition, using its Single-A bond rating, the Company has been able to refinance debt during the 2003-2004 period at rates that will save customers $154 million over the lives of the refinanced instruments. (TR Vol. 1 at 279-80).

The Commission finds that the provision of electric service is indeed a capital intensive business. As Mr. Marsh has testified, since 1992 SCE&G has invested over $2.4 billion in its generation system alone. (TR Vol. 1 at 271). Ongoing investment of this magnitude is required to meet the growing demands for electricity by customers in SCE&G's service territory. Such investment in energy infrastructure is also required to support the State's continued economic development, and to meet increasingly stringent environmental controls on electric generation. (TR Vol. 1 at 270-72). As a result, both SCE&G and its customers share an interest in SCE&G preserving its ability to access capital markets on reasonable terms. Maintaining balanced, stable and consistent regulation for the Company is indeed a goal that all parties to the regulatory process should share.

Both Mrs. Cannell and Mr. Marsh testified at length concerning the high level of attention investors are giving to this proceeding, and the likelihood that too rapid a reduction in SCE&G's ROE from the currently allowed 12.45% could cause investors to question the on-going stability and consistency of earnings for the Company. (TR Vol. 1 at 274-75; Vol. 2 at 552, 567). As Mrs. Cannell testified, constructive regulation supporting a consistent and predictable level of earnings over time is a key consideration for investors in evaluating the risk of investing in a utility and in determining what constitutes an appropriate share price. (TR Vol. 2 at 557-58). Mr. Marsh and Mrs. Cannell both testified in support of an ROE that does not rely exclusively on the outcome of DCF analyses, but instead reflects the unusual and unsustainable nature of current financial conditions. (TR Vol. 1 at 283-84; Vol. 2 at 568-69).

Stipulation and Settlement --As the Application in this proceeding indicates, SCE&G considered current financial conditions in requesting the Commission set rates based on an ROE of 11.75%. This request represents a 70 basis point reduction in the ROE of 12.45% that was authorized by this Commission less than two years ago. In the Stipulation and Settlement, SCE&G has indicated that it can effectively manage its finances, and maintain access to financial markets on reasonable terms, if the Commission were to establish a range of allowable ROE for the Company of 10.4% to 11.4% with rates set on an ROE of 10.9%, and if this ROE were accompanied by an overall revenue increase of $51 million. (TR Vol. 5 at 1525; Vol. 1 at 204, 323). The stipulation ROE of 10.9% represents a 155 basis point reduction in the currently allowed ROE of 12.45%. As Mr. Marsh has testified, the ROEs granted to SCE&G over the past 14 years have averaged 12%. (TR Vol. 1 at 283). Accordingly, the stipulation ROE also reflects an ROE that is substantially below the average ROE granted by the Commission for SCE&G over the past 14 years.

Five of the seven ROE witness (Dr. Malkiel, Mrs. Cannell, Mr. Osborne, Mr. Marsh and Mr. Pilalis) have testified in support of the stipulated ROE of 10.9% as appropriate when coupled with an overall revenue increase of $51 million. (TR Vol. 1 at

318, 322-323; Vol. 2 at 387-88, 530, 600; Vol. 5 at 1496, 1505-07). As Mr. Pilalis testified:

> *I . . .take the position that this Commission can and should consider the reasonableness of any nonlitigated resolution of this proceeding that may be presented in accordance with the Commission's applicable statutory mandate and procedural rules. It is my opinion that my study and the testimonies submitted by other parties in this proceeding, cumulatively present a series of estimated costs of common equity figures for SCE&G, which, in themselves, can provide the Commission with a range of alternatives in judging the reasonableness of any proposed nonlitigated resolution of this proceeding.*

(TR Vol. 5 at 1496).

The Company, the Commission Staff (representing the interests of all customers and the public in general), the South Carolina Energy Users Committee (representing SCE&G's large industrial customers), SMI-Steel Company (representing SCE&G's single largest industrial customer); and Wal-Mart Stores (representing SCE&G's largest commercial customer chain), have all endorsed the Stipulation and Settlement. (TR Vol. at). The fact that six witnesses of diverse backgrounds and credentials as well as the majority of parties in the proceeding have agreed to the reasonableness of the 10.9% ROE provides a strong basis in the record of this case for the Commission to accept it.

Conclusion Concerning ROE –Based on the testimony of Dr. Malkiel, Mr. Osborne, Mr. Marsh, and Mrs. Cannell, the Commission finds that it is appropriate to set an ROE in this case that takes into consideration factors in addition to current DCF results. Specifically, the Commission finds that pragmatic adjustments to these DCF results are required based on:

a. The historically low levels of interest rates currently;

b. The unsustainable nature of current interest rates;

c. The effect that the current interest rates have on DFC calculations of expected returns for utility companies;

d. The interest that all parties share in maintaining stable and predictable earnings levels for SCE&G, so long as the Company continues to be prudently and efficiently managed;

e. The dramatic one-time reductions in earnings that would otherwise result; and

f. The impact such a reduction could have on investors' expectation of the predictability and stability of the Company's earnings and the adverse consequences that could follow for all parties if investors' confidence in the Company should significantly weaken.

The Commission notes that the rates it sets in this proceeding will be in force for a minimum of one year, and perhaps significantly longer. Economic conditions are certain to change during the period that these rates are in effect. All indications are that these changes will involve rising interest rates and rising return expectations for utilities like SCE&G. Should economic conditions change as predicted, an ROE set solely with reference to current DCF results and current market conditions could rapidly prove to be insufficient, damaging SCE&G's financial position and its ability to obtain capital on reasonable rates until a new rate case could be filed and litigated. In addition, setting rates based exclusively on current conditions, without reference to historical ROE levels, makes it more likely that when future rate increases will be required, they will involve larger one-time increases with the greater disruption of customer expectations that would otherwise be involved. The Commission finds that in light of current economic conditions, and in light of the dramatic one-time reductions in earnings that would otherwise result, it is appropriate to set rates based on an ROE that reflects the unique, atypical and unsustainable nature of current economic conditions.

Accordingly, the Commission accepts as reliable and credible Dr. Malkiel's testimony that the 12.45% return granted in 2003 (12.0% without flotation adjustment) represents a reasonable upper bound on ROE's that might be granted in this case. As mentioned above, Dr. Malkiel's unadjusted DCF result before flotation adjustment (10.0%) defines the lower band of this range. As a result, the Commission finds that the stipulated ROE band of 10.4% to 11.4% falls well within the middle of the acceptable range of ROEs in this case, and that it is entirely just, reasonable and appropriate to set rates based on an ROE of 10.9%.

Flotation Adjustment –The Stipulation and Settlement affirms the 10.9% ROE as the basis on which rates will be set. It is not necessary to include flotation adjustment in Dr. Malkiel's ROE analysis, or any other analysis, to support setting rates at this figure. Accordingly, the Commission does not reach the question of whether a flotation adjustment is appropriate in this case.

2. CAPITAL STRUCTURE
(FINDING OF FACT NO. 32)

In keeping with established Commission practice, the Staff has updated the Company's capital structure, and cost of debt and preferred capital, to reflect the figures current at the time of the Staff's recent audit. (Hearing Exhibit 33, Audit Exhibit A-5) These underlying figures are not in dispute. The Consumer Advocate's witness, Mr. Watkins, initially challenged the Company's failure to include short-term debt in its capital structure for establishing its cost of capital. The Company's Witness, Mr. Marsh, however, demonstrated that this short-term debt is used to finance on-going construction work in progress and is reflected fully in calculating the Allowance for Funds Used During Construction ("AFUDC") that applies to that construction investment. Accordingly, Mr. Watkins has withdrawn his challenge and the Commission affirms that short-term debt is property accounted for in the AFUDC calculation, not in computing long-term capital costs.

3. EMBEDDED RATE OF LONG-TERM DEBT AND PREFERRED STOCK (FINDING OF FACT NO. 33)

The Commission's determination concerning the amount and cost of long-term debt and preferred stock is based on the embedded rates of those instruments as shown in the Company's books and records. The rates used are the actual rates in force on September 30, 2004 determined subject to Staff audit of the Company's books and records. The values are as show in the above-referenced finding of fact.

I. EVIDENCE AND CONCLUSIONS CONCERNING RATE DESIGN (FINDING OF FACT NOS. 35-36)

1. GENERAL PRINCIPLES

Upon the identification of revenue requirements, the Commission is responsible for determining specific rates and developing a rate structure that will yield required revenues. It is generally accepted that proper utility regulation requires the exercise of control over the rate structure to insure that equitable treatment is afforded each class of customer.

The Commission's statutory responsibility to fix "just and reasonable rates" [S.C., Code Ann. §§ 58-3-140, 58-27-810 (1976)] has been exercised by the recognition of the objective to provide a utility a fair opportunity to earn a reasonable return, which meets the established revenue requirement and equitably apportions the revenue responsibility among classes of service. In discharging the Commission's responsibility to fix "just and reasonable rates," we have traditionally adhered to the following criteria:

> …(a) the revenue-requirement or financial-need objective, which takes the form of a fair-return standard with respect to private utility companies; (b) the fair-cost-apportionment objective, which invokes the principle that the burden of meeting total revenue requirements must be distributed fairly among the beneficiaries of the service; and (c) the optimum-use or customer-rationing objective, under which the rates are designed to discourage the wasteful use of public utility services while promoting all use that is economically justified in view of the relationships between cost incurred and benefits received.

Bonbright, *Principles of Public Utility Rates* at 292 (1961).

These criteria have been consistently observed by this Commission and again are utilized here.

The cost of supplying electricity to different customer classes is a function of many variable factors, therefore, the allocation of these costs among the different classes of customers requires a sophisticated process. The procedure generally used by this Commission in analyzing utility costs in the context of the review of rate design provides for the distribution of total costs among three major categories: (1) costs that are a function of the total number of customers, (2) costs that are a function of the volume of the service supplied (energy costs), and (3) costs that are a function of the service capacity of plant and equipment in terms of their capability to carry hourly or daily peak loads (demand costs).

In concluding that rates should be based on cost of service principles, the Commission espouses the economic theory that regulation is intended to act as a surrogate for competition by insuring that each rate that is charged for electricity is fair and reasonable. That is, that utility rates are maintained at the level of costs, including a fair return on capital. By incorporating cost of service principles, the Commission provides for rates and charges which are designed to promote equity, engineering efficiency (cost-minimization), conservation and stability.

Company witness, John Hendrix, discussed the Company's adherence to the foregoing principles in its processes for developing rates. His testimony consisted of three major subject areas: cost of service, rate design, and general terms and conditions. Mr. Hendrix, sponsored the utility's cost study and supported the resultant rates and charges. (Hearing Exhibit 21 [JRH-1-5]); (TR Vol. 3 at 834-859).

2. COST OF SERVICE STUDY

The foundation for an equitable and efficient, cost-based rate structure is a cost of service study, which accounts for the variable factors from which are derived the costs of supplying electricity to different classes of customers. The cost of service study not only identifies the total cost of service and thereby measures the profitability of the utility, but also identifies cost by function and class of service, and so measures the compensability of service to any one customer class. Furthermore, the cost of service study is used to assess the propriety of any one particular rate structure in the design of rates. A cost of service study functions as a regulatory guide by which the ratemaker can determine the existing rate of return of each class and the manner and extent to which is should be adjusted to achieve cost-based rates.

The principle steps in developing the cost of service study were the functionalization of costs, classification of cost, and allocation of costs. (TR Vol. 3 at 838-839). Functions include production, transmission, and distribution. Classifications are identified as customer, demand, and energy. The final step in the process is the allocation of costs to classes of service. (TR Vol. 3 at 839-851).

Customer costs, which vary with the number and size of customers, are direct costs which customers place on the system simply by being connected with service drop. (*Id.* at 840-841). Accordingly, the Company developed factors used for allocating billing expenses between customer classes by ascertaining equivalent levels of service. (*Id.*).

Demand costs are the fixed costs of building and operating the system required to serve the Company's customer base. The cost of service study utilizes two basic demand allocators. The coincident peak allocator was developed based on the system territorial four-hour peak demand. The non-coincident peak allocator was developed by combining the non-coincident peak demands of each class of customers when they were incurred during the test year. (*Id.* at 842-844).

The energy allocator was developed from the annual kilowatt-sales by class of customer adjusted for system losses. The Company collected data on energy usage by customer class and used actual test period data in making this allocation. (*Id.* at 844-846).

Following classification, the revenue, expense and rate base items were allocated according to function or purpose. (*Id.* at 848-850). This process is essential to a fair allocation of revenue requirements for the utility system, which requires the separation of costs associated with each customer class and with the utility's jurisdictional operations.

The Company's cost of service study, utilized in the design of the proposed rates and charges, are based on principles and methodologies that have long been accepted by this Commission. (TR Vol. 3 at 836; Vol. 4 at 1371-1372) There is no evidence in the record of this proceeding to cause the Commission to abandon its well-founded reliance upon these principles and methodologies. The Commission also hereby reaffirms the single Four Hour Band Coincident Peak Methodology for ratemaking purposes, adopted in its Order No. 96-15.

No Intervenor challenged the validity of the Company's cost of service study. (*Id.* at 861). The cost of service study presented provides a proper foundation for distributing costs among classes since it recognizes cost causation and distributes costs accordingly. This study also provides a proper basis for determining cost-based rates and is a major component of fair and equitable rate design. The cost of service study also provides a reasonably accurate measure of cost causation among classes of customers. (TR Vol. 3 at 836). Accordingly, the Commission hereby approves the Company's proposed cost of service study.

3. ALLOCATIONS AND REVENUE REQUESTS

This Commission has considered it axiomatic that retail rates should produce rates of return among classes which bear a reasonable relationship to the Company's overall rate of return. Further, there should be movement towards equal rates of return among the classes. PSC Order 96-15 (Docket No. 95-1000-G) at 70 (January 9, 1996)

In addition to cost of service, other factors guided the Company in designing its rates. These factors were value of service, rate history, revenue stability, improvement of system load factor, and optimum use of natural resources. (TR Vol. 3 at 838-851).

The result of the application of the factors utilized by the Company, objective and subjective, was the rate of return relationships set forth in Hearing Exhibit 21 (JRH-3):

SOUTH CAROLINA ELECTRIC & GAS
CLASS RATE OF RETURN RELATIONSHIPS

	BEFORE INCREASE			AFTER INCREASE	
	RATE OF RETURN (COL. 1)	% OF RETAIL ROR (COL. 2)	% INCREASE (COL. 3)	RATE OF RETURN (COL. 4)	RELATIONSHIP (COL. 5)
RESIDENTIAL	6.64%	87%	8.81%	8.87%	97%
SMALL	8.68%	114%	3.31%	9.49%	103%
MEDIUM	7.95%	104%	5.01%	9.34%	102%
LARGE	8.66%	114%	2.01%	9.47%	103%
LIGHTING	8.18%	107%	6.25%	9.58%	104%
TOTAL RETAIL	7.61%	100%	5.66%	9.18%	100%

Mr. Hendrix testified that these relationships were significant in order to adhere to the Commission's long-standing objective of establishing rates among classes of customers calculated to produce rates of return by class which bear a reasonable relationship to the Company’s overall rate of return.

A "reasonable" relationship has been considered to be within 10% plus or minus of the overall return. This basic principle has been used by the Company and approved by the Commission for many years. In this particular case, the relationship is 5%. Thus, the proposed revenue spread puts all classes of customers within this band of reasonableness.

Finally, the Company has consistently applied this same allocation process in implementing the overall adjustment in rates resulting from the Stipulation and Settlement in this case. The Commission therefore approves same.

4. CONCLUSION

The Commission is mindful of the implications of a rate increase on any class of customers and, indeed, any customer. The Commission is also mindful of the requirements of the utilities which it regulates and the need for decisions which strategically balance the needs of a utility and its customers. The Commission is persuaded by the reasonableness and fairness of the Company's methodology in ultimately establishing the rates for each of its customer classes. The Commission recognizes that subjective judgment enters into this process, but finds and concludes that the process followed by the Company is based on substantial experience and data and results in rates which fairly and reasonably produce revenues from each customer class, as to each class specifically, and in relationship to the other classes. The Commission finds that the Company's rate structure properly prices the services offered by the Company's various rates and sends proper price signals to each class of customers. The Company properly allocates its fixed costs in demand charges and properly allocates variable costs in the energy charges.

Therefore, apart from the matters separately addressed below, the rate designs proposed by the Company are accepted and approved. Any reduction in the level or rate increase requested by the Company shall be allocated to customer classes in the same proportion as the Company requested the increase to customer classes.

J. TARIFFS AND TERMS AND CONDITIONS OF SERVICE (FINDING OF FACT NO. 36)

The Company has proposed several changes to its Tariffs and Terms and Conditions of Service. The following, however, merit specific reference:

1. In Section III (K) at 6 of its Application, the Company requests that its reconnection charges be increased from $15.00 to $25.00. Additionally, the Company proposes to charge this fee for each trip made to a customer location, even if reconnection is not established, if the failure to reconnect is due to the customer's failure to take required actions. This failure could range from the failure to provide access to customer premises to the failure of the customer to follow Company instructions. The Company witness, John R. Hendrix, testified that the actual cost to the Company of performing reconnection during working hours is $39.21. (TR Vol. 3 at 854).

   The Commission finds that the proposed changes and charges are reasonable in light of the actual cost to the Company and, therefore, approves same. Pursuant to the Stipulation and Settlement, discussed above, the signing parties have agreed that the language pertaining to the imposition of the charge regardless of whether reconnection is accomplished due to the failure of the customer shall be deleted. Therefore, this change in Terms and Conditions is approved without that provision.

2. The Company has requested a new section in its General Terms and Conditions which would allow SCE&G to collect deposits from non-residential customers, that are not sole proprietorships, whose electric bills

total at least $25,000.00 or more per billing period for at least three (3) billing periods of the previous twelve (12) months. Company witness, Hendrix, presented testimony documenting the justification for the deposits sought. However, in the Stipulation and Settlement, this request has been withdrawn.

3. The Basic Facility Charges, as set forth in the proposed rates and in the pre-filed exhibit of Company witness, Hearing Exhibit 21 (JRH–4) have been specifically concurred in by the parties to the Stipulation and Settlement and are otherwise unopposed and are, therefore, approved.
4. In its Application the Company proposes a new interruptible Service Rider to make interruptible credits available to customers receiving service under Rates 23 or 24 who can contract for interruption of 1000 KW or more during the period June through September. The rider would specifically allow the Company to interrupt customers receiving credits under it for economic reasons, in addition to reliability and system emergency considerations, and would allow the customers the right to buy through economic interruptions at the market rate applicable at the time. The Company proposes to continue its current Interruptible Service Rider but close it to new participants. As a part of the Stipulation and Settlement in this case, the Company has withdrawn its request for the new Interruptible Service Rider and has agreed to keep the current Interruptible Service Rider in place and available to new participants and has increased the interruptible cap thereon to 150,000 KW.

Except as modified by the discussion above, the Commission finds all of the Company's requested changes in Tariffs and Terms and Conditions to be reasonable and appropriate and supported by the record in this case, and therefore, approves the same.

K. EVIDENCE AND CONCLUSIONS REGARDING ACCELERATED DEPRECIATION MECHANISM (FINDING OF FACT NO. 37)

In our Order No. 1999-655 in Docket No. 1999-389-E, the Commission allowed the Company to accelerate depreciation of its Cope Generating Station when revenue and expense levels warranted. When invoked, the Company records additional depreciation related to the Cope facility, which increases expenses and thereby reduces earnings. The mechanism enables the Company to respond to short-term levels of expenses or revenues, without adjustments in rates which would have long-term implications. The Commission maintains at all times the ability to initiate a rate reduction proceeding if it believes that the Company's earnings will be higher than approved levels on a sustained basis. The Company has requested that the Commission extend until December 31, 2010, the period over which it would be able to apply the accelerated capital recovery mechanism, which would otherwise expire on December 31, 2005. Based on the testimony of Company witness Kevin Marsh, the Commission believes this request is in the best interest of the Company and its customers. (TR Vol. 1 at 284-285, 293-294, 320-322). SCE&G ratepayers obtain benefits in that downward pressure is placed on electric rates over the long term: (a) the depreciated book value of the generation rate base used to serve native load customers is reduced, and (b) the Company preserves the ability to make ongoing investments in rate base to meet customer and Company needs, without necessarily having to increase rates to recover such investments. In this way, customers obtain the benefit of a reduction in the depreciated book value of the generation rate base used to serve them, the utility becomes more cost-competitive because of the reduction in the net book value of its generating assets, and shareholders and bondholders receive a return on their investment in those assets. Such a mechanism also sustains a stable regulatory environment during the time when the Company experiences an increased level of earnings. The Commission agrees with Mr. Marsh, that the reasons supporting the Commission's initial decision regarding this mechanism are still valid today and the requested extension is hereby granted. As pointed out by the Company's depreciation witness, John Spanos, for production facilities, the accelerated depreciation would be financially accounted for in compliance with FAS 71. This accounting treatment would not affect the useful life of the plant.

L. CONCLUSION CONCERNING STIPULATION AND SETTLEMENT

For the reasons stated above, the Commission finds the terms of the Stipulation and Settlement to be reasonable and prudent and and supported by the substantial evidence on the record in this proceeding. The Commission finds that by approving the terms of the Stipulation and Settlement, it will create rates, and terms and conditions of service for SCE&G that are just and reasonable and supportive of the interests of all parties. The Commission therefore, approves the terms of the Stipulation and Settlement as the fully supportive of the decision of the Commission in this matter.

VI. DECREE

WHEREFORE, it is ordered:

1. That South Carolina Electric & Gas Company shall implement the rate schedules that conform to the findings of this Order for service rendered on or after January 1, 2005.

2. That South Carolina Electric & Gas Company shall within ten (10) days from its receipt of this Order file with the Commission rate schedules and terms and conditions of service that incorporate the findings in this Order.

3. That this Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

____
Randy Mitchell, Chairman

Attest:

____

CONCLUSION

Undersigned counsel respectfully submits this post-hearing memorandum in the form of a proposed order requests that the Commission issue an order ruling as indicated above.

Signed,

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/s/
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TAB A

BEFORE THE PUBLIC SERVICE COMMISSION OF
SOUTH CAROLINA
DOCKET NO. 2004-178-E
December _____, 2004

IN RE: Application of South Carolina Electric & Gas Company for Adjustments in the Company's Electric Rate Schedules and Tariffs	)	POST HEARING BRIEF OF SOUTH CAROLINA ELECTRIC & GAS COMPANY IN THE FORM OF A PROPOSED ORDER

APPENDIX OF SCE&G (COMPANY)

SCE&G respectfully requests, if the Commission does not approve in its entirety the Stipulation and Settlement, that the Commission approve SCE&G's requests and prayers in this matter as filed in it Application and supported by its testimony and the record in this matter. Specifically, the Company requests that the following relief be granted:

1. That SCE&G receive an increase in its electric retail rates to produce an additional $81,192,000.
2. That the proper capitalization for determining SCE&G's rates and charges shall be the capitalization as of August 31, 2004, as set forth in the Staff Report (Hearing Exhibit 33);
3. That, as supported by the evidence of record and discussion in this Proposed Order, the Return on Common Equity ("ROE") for the Company shall be in the range of 10.5-12.45%, with 11.75% being utilized for setting rates;
4. That the capital costs, O&M expenses and depreciation expenses related to the Jasper plant are approved as set forth in the pre-filed direct testimony of Witness Carlette Walker (TR Vol. 2 at 705-735; Vol. 3 at 741-831). The Commission's Order approving the siting of the Jasper Plant (Order No. 2002-19) determined that the plant

is properly sized at 875 MW when the 250 MW opportunity sale from system resources to the North Carolina Electric Membership Corporation ("NCEMC") is taken into account, and further that the Commission's Order in the last SCE&G electric rate proceeding (Order No. 2003-38) properly determined that the plant was used and useful for utility purposes in its 875 MW configuration. The Company has properly accounted for the revenue related to both the 250 MW and 100 MW sales of capacity and energy made to NCEMC and has properly treated these sales as opportunity sales;

5. That the treatment of fixed pipeline capacity charges requested by the Company, as set forth in the testimony of Witness Carlette Walker (TR Vol. 2 at 705-735; Vol. 3 at 741-831), and this treatment will result in no net change in charges to customers;

6. The Company's proposal concerning the capital costs of the Saluda Dam Remediation project. The method for recovery of capital costs and the required accounting treatment is outlined in this Proposed Order;

7. The Company's proposal related to the deferral and amortization of certain amounts related to its long-term disability program as outlined by Witness Carlette Walker (TR Vol. 2 at 705-735; Vol. 3 at 741-831), with an amortization of five (5) years;

8. The Company's proposal for the treatment of costs related to the formation of the GridSouth Regional Transmission Organization as outlined by Witness Carlette Walker (TR Vol. 2 at 705-735; Vol. 3 at 741-831), including carrying costs;

9. The Company's proposal for annualization of turbine maintenance expenses in order to levelize the cost over an eight (8) year period as outlined by Witness Carlette Walker (TR Vol. 2 at 705-735; Vol. 3 at 741-831);

10. The Company’s proposal related to the unrecovered fuel component of Purchased Power based on the stipulation approved by the Commission in Docket No. 2004-2-E (TR Vol. 4 at 1430) (Hearing Ex. 38);

11. The Company’s Depreciation Study filed in this case and conducted under the direction and supervision of Company Witness Spanos, and this study is the basis used by SCE&G for both rate-making purposes and for accounting purposes;

12. The Company’s request for an extension until December 31, 2010, for the accelerated capital recovery mechanism to its Cope Generating Station, as originally approved in Commission Order No. 1999-655, and the upper end of the ROE range (12.45%) is the triggering return on common equity for application of this mechanism;

13. The Company’s request for executive compensation attributable to SCE&G electric operations as found in Vol. 2 at 693, including the increase in salary and the incremental compensation paid to the five (5) Company officers listed in SCANA’s Proxy Statement;

14. The Company’s request for adjustment to Plant in Service and O&M expense for costs of compliance with new NERC standards be approved;

15. The amount of employee moving expenses included in the Company’s test year;

16. All other accounting and pro forma adjustments as set forth by the Company in its Application, and supported by its testimony and the evidence of record;

17. The allocations used by the Company in its cost of service study, which is the same methodology used for at least the last 25 years and which was also approved by the Commission in the Company’s last electric rate proceeding order (Order No. 2003-

38), and this cost of service study therefore shall serve as the basis for the revenue increase and the Company's rate design

18. The Basic Facility Charges as set forth in the testimony of Witness Hendrix (TR Vol. 3 at 851) and in the proposed rates (TR Vol. 3 at 851-853);

19. All other charges, tariffs, and Terms and Conditions proposals as set forth in the Company's Application and supported by the Company's testimony, including reconnection charges, the new economic Interruptible Service Rider, and the proposed language for General Terms and Conditions Section IV(D)(5).

TAB B

APPENDIX OF THE COMMISSION STAFF

I.
INTRODUCTION

The Commission Staff of the Public Service Commission of South Carolina supports the Stipulation and Settlement (the Agreement) entered into between SCE&G, the Staff, the South Carolina Energy Users Committee, SMI Steel, and Wal-Mart as a proper resolution of the issues in this case. However, should the Commission reject the Agreement, the Staff herein furnishes proposed language for the Commission's adoption, should the Commission decide to adopt the Commission Staff's original positions. The proposed language is adopted from Staff's original testimony and exhibits and does not include language supporting the various proposals included in the Agreement.

II.
EVIDENCE AND CONCLUSIONS REGARDING ACCOUNTING AND PRO FORMA ADJUSTMENTS

1. NCEMC CONTRACTS

Both the Company and the Staff propose to annualize the revenues associated with two contracts for sale of capacity and energy by SCE&G to the North Carolina Electric Membership Corporation. These sales are made under two separate contracts, one for 100 MW for a term of 2 years and one for 250 MW for a term of 9 years. Tr. Vol. II, Walker at 690.While the Company and the Staff agree on the gross amount of the adjustment, which is $30,099,000 total electric and $28,280,000 retail, with appropriate income tax effects as listed, the Commission Audit Staff is proposing to increase "other taxes" by $144,808 on a total electric company basis to include the gross receipts taxes applicable to such revenue. The Staff's Utilities Department computed the electric retail amount of the adjustment to other taxes to be $139,000. Tr., Vol. 4, Scott at 1294. This additional adjustment to "other taxes" is reasonable under the circumstances stated, and we hereby approve the additional adjustment, as well as the original adjustment to total electric gross revenue. Also, see discussion infra.

2. FUEL COMPONENT OF PURCHASED POWER

The Staff agreed with the Company that an adjustment should be made to amortize over three years the fuel component of purchased power that has not been recovered through the fuel adjustment clause. The adjustment is made in accordance with the stipulation approved by the Commission in Docket No. 2004-02-E. This adjustment increases test year expenses related to purchased power by $8,539,354. Tr.,Vol. 2, Walker at 691. Staff proposes to allocate the full amount to retail operations. Hearing Exhibit 33, Audit Exhibit A-1, page 1 of 12. Consumer Advocate witness Watkins opines that a five year amortization period should be used for, among other reasons, that the period is more equitable to ratepayers. Tr., Vol. 3, Watkins at 960. We agree with the Company and Staff that three years is a more reasonable time frame for the amortization of the fuel component. As a general principle, when dealing with costs that have accrued incrementally over time, it is preferable to choose amortization periods that reasonably correspond to the accumulation period. In this case, the costs in question accumulated over a two year period. Three years is closer to this period than the Consumer

Advocate's proposed five year period. Tr., Vol. 2, Walker at 709. Accordingly, we adopt Staff's and Company's three year amortization period.

With regard to the adjustment For Fuel Costs tariff, the Company inserted additional wording in two paragraphs of that tariff to comply with and reflect the language in the latest version of the fuel cost statute. The addition to paragraph (B) tracks the latest language in S.C. Code Ann. Section 58-27-865(A)(2)(a) and the added language in paragraph (C) tracks that in Section 58-27-865(A)(2)(b). The language added to these two paragraphs is consistent with the statute with the exception of the omission in paragraph (C), of the words "including, but not limited to, transmission charges" when referring to economy purchases. This correction should be made to the Company's Fuel Cost tariff to accurately reflect the language in the statute. Tr., Vol. 4, Watts at 1378.

3. TURBINE MAINTENANCE EXPENSES

The Company proposed an annualized adjustment to turbine operating and maintenance expense to account for increased costs most notably associated with the new combined cycle units at Urquhart and Jasper. The adjustment includes only specific major maintenance activities anticipated to occur during an eight-year cycle and will be performed by special labor force professionals comprised of outside staff personnel. The Company also proposes to compare the actual annual costs to the expense level and book any difference to regulatory asset or liability accounts which would be subject to further order of the Commission. Tr., Vol. 4, Watts at 1373. The Commission Staff, through witness Watts, recognizes the fact that these essential activities will result in additional expenses. However, due to more uncertainty associated with projections in the later part of the proposed eight-year cycle, Watts recommended using an average of the initial four years with booking of the difference between actual costs and the level allowed in rates. In addition, under Watts' approach, the Company would provide a report of these booked amounts at the end of three years in order to allow the Commission to review the results for any further action that it finds appropriate. Id. at 1374.

Various other parties took different views on the matter. Navy witness Smith proposed a reduction of SCE&G's proposed amount in two ways: (1) to reflect current value dollar amounts of the future year expenditures used by SCE&G in its proposed adjustment; and (2) to reflect five years as the initial "trial" period for the levelization, rather than the eight years proposed by SCE&G. Tr. Vol. 4, Smith at 1184-1185. Smith believes that future cash flows should be discounted to current dollar values so the current impact can be determined. Id. at 1185. Also, Smith states that 2005 through 2009 includes substantial maintenance at Urquhart and Jasper, and should be fairly representative of high and low years. Id. at 1186. Consumer Advocate witness Watkins states that the proposal should be rejected, since he opines that the costs are not known and measurable, but are merely forecasts, and the costs should be capitalized. Tr.,Vol. 3, Watkins at 961.

We reject these allegations. Company witness Marsh notes that the attempted classification of turbine and generator maintenance expenses as capital costs or capital investments is not correct. Costs incurred to maintain the operation of equipment must be classified as maintenance expense, which is not a capital expenditure. Tr., Vol. 5, Marsh at 1601. Further, on the known and measurable issue, Marsh notes that the fact that the costs will be incurred is fully known. The maintenance in question is an engineering requirement. Marsh states that the manufacturers of SCE&G's turbines and generators have specified very detailed and prescriptive schedules of required maintenance. Accordingly, the fact that this maintenance will be required is an engineering certainty, and is fully known. Id.

In addition, Marsh states that the costs are also reasonably measurable. The Company has a long history of experience in maintaining its existing steam plants. With regard to the turbines and generators at Jasper and Urquhart, costs are measurable based on the manufacturer's maintenance specifications, which are based on the manufacturer's understanding of the design and engineering requirement of the units. The pro forma adjustment for turbine maintenance is based on the results of consultations with the manufacturer and a jointly prepared work and cost schedule. This appears to be more economical than the manufacturer's proposed "turn-key" approach. We also reject the Navy's proposals as being unnecessary and because of the fact that the proposed eight year cycle is reasonable under the circumstance, especially utilizing witness Watts' approach. We approve the methodology outlined in Staff's testimony for turbine maintenance.

4. AMMONIA

Both the Company and the Staff propose to increase operating and maintenance expenses for the costs associated with the use of ammonia in three new Selective Catalytic Reactor Units. The Staff annualized actual ammonia expenses for this year's 4-month ozone season over 5 months to reflect the length of the future ozone season.

Staff's adjustment totaled $1,152,549 on a total electric basis. Tr. Vol. 4, Scott at 1295. The Utilities Department computed the retail electric amount to be $1,080,000. Id. The Company states that the Company's experience should be annualized during the initial months of plant operations, and reflective of current ammonia prices. Tr., Vol. 2, Walker at 710. Consumer Advocate witness Watkins proposed an adjustment to reflect the actual June 2004 cost of ammonia. Tr., Vol. 3, Watkins at 962. We disagree with the Company and the Consumer Advocate, and state that Staff's methodology was proper, in that it more properly reflects the expenditures that will be required in future ozone seasons. We adopt Staff's adjustment.

5. WAGE AND EMPLOYEE BENEFITS

Both the Company and the Staff propose to annualize wage increases that were effective in March 2004 and adjust corresponding employee benefits and payroll taxes. The Staff used FICA rates and removed amounts above the base in determining the associated payroll tax increase. Hearing Exhibit 33, Audit Exhibit A-1, Page 3 of 12. This adjustment amounted to $6,511,153 on a total electric Company basis. Tr., Vol. 2, Walker at 693. Staff's computation of other taxes amounted to $421,822 on a total electric company basis. The Staff's Utilities Department determined the allocation to retail electric operations to be an increase to other taxes of $405,000. Tr., Vol. 4, Scott at 1296. We adopt Staff's proposals.

6. PENSION PLAN ASSETS

Both the Company and the Staff propose to decrease expenses to reflect increased income from the Company's pension plan assets. Income from such assets is used to offset pension expenses. The Company's adjustment is based on information provided by its actuaries. Staff accepted the Company's adjustment after reviewing the latest estimates from the Company's actuaries. Hearing Exhibit 33, Audit Exhibit A-1, Page 3 of 12. This expense is uncontested.

7. POST-EMPLOYMENT BENEFITS
OTHER THAN PENSIONS

The Company and Staff propose to annualize the expenses for post employment benefits other than pensions (OPEB's) to match the amounts required to be accrued for these expenses. This adjustment annualizes the electric O & M portion of the Company's expenses for OPEB's, principally post-retirement health care benefits. The Staff used the amount from an updated actuarial study in arriving at an adjustment to increase O & M expenses by $1,507,881 on a total electric Company basis. The Staff computed a reduction in rate base to be $931,117 on a total electric basis. On a retail electric basis, these adjustments are $1,438,000 to O & M expenses and ($894,000) to rate base. Tr., Vol. 4, Scott at 1296. We adopt Staff's adjustment, since it is based on the latest actuarial study available.

8. LONG TERM DISABILITY

The Company proposed to amortize deferred costs associated with its long term disability plan over a five year period. Financial Accounting Standards Board (FASB) 112 requires that a liability be recognized for the deferred expenses associated with this cost. The Company booked a liability of $8,280,470 on a total electric basis for such deferred expenses. The Company proposed to amortize the liability over a five year period by recognizing a total electric expense of $1,656,094 in the test year. The Commission Staff traced the amount of the liability to the Company's books and records during the audit. Staff proposes to amortize the liability over nine (9) years which represents the average amount of time a participant in the Long Term Disability plan would receive benefits. Therefore, the Staff proposes to increase O & M expenses by $920,052 on a total electric basis for the test year. The retail electric amount of the Staff adjustment is $877,000. Tr., Vol. 4, Scott at 1297. The Company requests an adjustment to expenses of $1,656,094. Tr., Vol. 2, Walker at 695.

The Department of the Navy contests the Company's proposed adjustment. According to Navy witness Smith, the Company has failed to show how an amortization of the FAS 112 post employment benefit obligation is relevant or appropriate to the test year. Tr., Vol. 4, Smith at 1177. Smith notes that, while the Company did record a deferral on its books, the deferred debt and credit balances on SCE&G's books as of the end of the test year are equal. Id. Thus, Smith concludes that there is no net amount that would be required to be amortized into future expense for ratemaking purposes.

The rebuttal testimony of Company witness Walker is significant, however. Ms. Walker points out that the deferred asset can only be amortized as amounts are collected through rates. Accordingly, unless amortization is allowed, there is no means for the deferred asset to be reduced. Tr., Vol. 2, Walker at 711. Ms. Walker properly rebuts Smith's additional assertions.

We adopt the Staff position of amortizing these expenses over nine (9) years, which is the average amount of time a participant in the Long Term Disability plan would receive benefits.

9. EMPLOYEE CLUBS

The Staff and the Company both proposed an adjustment to lower rate base and expenses associated with employee clubs. However, the Staff found two projects in completed construction work not classified that were for employee clubs. Staff lowered plant in service by an additional $690,557 on a total electric Company basis to remove such projects from rate base. Staff removed a total of $3,809,000 on a total Company basis. The Utilities Department provided the additional Electric Retail amount of $663,211. Staff removed a total of $3,658,000 on a retail electric basis. Tr. Vol. 4, Scott at 1297-1298. We adopt Staff's adjustments, since they included the additional projects noted.

10. TOTAL ELECTRIC PLANT IN SERVICE

Both Company and Staff propose an adjustment to increase total electric plant in service by $75,281,937 to reflect the May 31, 2004 balance. Both also proposed to decrease Construction Work in Progress and Accumulated Depreciation for plant additions and other pro forma retirements as of May 31, 2004. Hearing Exhibit No. 33, Audit Exhibit A-1, Page 5 of 12. This adjustment is adopted.

11. NERC RATE BASE AND EXPENSE LEVELS

The Company estimated the rate base and expense levels that it believes will be incurred in order to comply with new North American Electric Reliability (NERC) standards.

Messrs. Watkins and Smith objected to inclusion of these costs. Tr., Vol. 2, Walker at 712. The Commission Audit Staff could not verify the adjustment because it was based on estimated amounts. The Staff verified actual costs consisting of $12,156 on a total electric basis in the construction work in progress (CWIP) account. The Staff proposes to include that amount in rate base. The retail electric amount is $11,666. This actual amount is adopted, since it is based on actual known costs.

12. DEPRECIATION EXPENSE

The Staff and Company both propose to annualize depreciation expense and adjust the depreciation reserve based on plant in service at May 31, 2004 and currently approved depreciation rates. Staff, however, removed plant for employee clubs and excluded plant for NERC standards before computing annualized depreciation expense. Staff computed an expense adjustment of $7,437,535 on a total electric Company basis. The retail electric amount of the expense is $7,116,000. Tr., Vol. 4, Scott at 1299-1300. We adopt the Staff's adjustment.

13. EXPENSE FOR DEPRECIATION STUDY

The Staff and Company both propose to increase depreciation expense and depreciation reserves for a new depreciation study based on plant in service at May 31, 2004.

According to the testimony of Staff witness Watts, the new study was performed using standard property grouping procedures, service life, salvage value and remaining life techniques along with an examination and analysis of the Company's associated historical data as well as future expectations applicable to depreciable plant balances as of December 31, 2003. The new rates basically resulted from use of the straight line method and the remaining and average service life depreciation procedures. The study includes the effect of the extension of the service life of the VC Summer Nuclear Plant resulting from relicensing by the Nuclear Regulatory Commission as well as a composite rate of 4.00% for the Jasper facility. In addition, the Company is requesting that in the future it be allowed to book depreciation expense based on the rates for the individual plant accounts as listed in the proposed study instead of on a composite basis as has previously been the case. Application of rates for individual plant accounts would appear to result in an even more precise accrual than using composites and should help to further minimize the risk of specific account amounts deviating excessively from actual experience. Staff states that the study is based on sound logic and practices. Tr., Vol. 4, Watts at 1374-1375. See also Tr., Vol. 2, Spanos at 641.

Staff has again removed plant for employee clubs and excluded plant for NERC standards before computing annualized depreciation expense using the rates from the new study. The Utilities Department reviewed the new depreciation rates that the Company proposed to use in this adjustment. Staff's depreciation Expense adjustment for the new Depreciation study amounted to $12,222,912. The retail electric amount is $11,420,000. We adopt the Staff adjustment.

14. PROPERTY TAXES

The Company proposes to increase property taxes by $5,501,000 on a total Company basis using plant additions. The proposed retail amount of increased property taxes is $5,280,000. The Staff annualized property taxes based on an as adjusted net plant in service which did not include plant for employee clubs and NERC standards. Staff increased property tax expense by $5,444,576 on a total Company basis. The retail electric amount is $5,226,000. We adopt Staff's adjustment. Tr.,Vol. 4, Scott at 1300-1301.

15. JASPER PLANT

The Staff and Company propose to adjust for the effects of the Jasper plant starting commercial operations in May 2004. The Staff annualized Other Operating and Maintenance expenses and Taxes Other Than Income based on actual expenses from May 2004 through September 2004. Staff annualized total actual expenses for a total company adjustment of $4,336,549 for Other Operating Expenses and added $158,216 for Taxes Other Than Income. The retail amount was computed to be $4,090,000 for Other Operating Expenses and $5,126,000 for Taxes Other Than Income. Staff had no differences with the Company with regard to Fuel Costs, Plant in Service, CWIP, Depreciation and Accumulated Depreciation. However, the Staff recommends that the Company not be allowed to continue to accrue an allowance for funds used during construction (AFUDC) on the Jasper amounts and any other CWIP projects at the level included in rate base as a result of this proceeding. Staff notes that it is necessary to cease the accrual of AFUDC because the Company will now be earning a return on the CWIP that is included in rate base. Tr., Vol. 4, Scott at 1301-1302.

Although we are mindful of the testimony of Dr. David Dismukes, we believe that our siting Order for the Jasper Plant, Order No. 2002-19 properly determined that the Jasper Plant is properly sized at 875 MW when the 250 MW opportunity sale from system resources to North Carolina Electric Membership Corporation is taken into account. We also believe that our Order in the last SCE&G electric rate proceeding, Order No. 2003-38, properly determined that the plant was used and useful for utility purposes in its 875 MW configuration. Lastly, we believe that the Company has properly accounted for the revenue related to both the 250 MW and 100 MW sales of capacity and energy made to North Carolina Electric Membership Corporation and have properly treated those sales as opportunity sales. Dr. Dismukes' testimony attempts to challenge what has already been established, i.e., that the Jasper Plant is properly sized and that the plant is used and useful in its 875 MW configuration. We see no basis to reopen these matters. Accordingly, the updated Jasper capital costs and expenses are appropriate and are approved as stated by Staff.

16. SALUDA DAM REMEDIATION

Both the Company and the Staff propose to remove the costs related to the Saluda Dam remediation project from this case. The Company's proposal to use synthetic fuel credits to fund the project and its accounting treatment is described in the testimony of Company witness Addison. Tr., Vol. 2, Addison at 615-620. No cost to the SCE&G ratepayer results from the Company's methodology. No party opposed the proposal, and it is accordingly adopted.

17. MATERIALS AND SUPPLIES

The Company originally proposed an increase of $23,340,000 to Materials and Supplies Inventory to increase the value of coal inventory to reflect current market prices and normal inventory levels. The Company made a correction after the filing, proposing an increase of $13,256,666. The Staff agrees with the revised proposed increase, notwithstanding the objections of Messrs. Watkins and Smith. The electric retail amount of the increase is $12,339,000. Tr., Vol. 4, Scott at 1302, Hearing Exhibit 33, Audit Exhibit A-1, page 7 of 12. We approve Staff's adjustment.

18. GRIDSOUTH RTO COSTS

The GridSouth Regional Transmission Organization (RTO) Project was established in response to directives from the Federal Energy Regulatory Commission (FERC) mandating creation of regional transmission organizations. The FERC's policies concerning RTOs appear to be a moving target and even now, continue to evolve. Tr., Vol. 4, Watts at 1375. Both the Company and the Staff propose amortizing the Company's total project costs over a five-year period. The Staff examined $14,118,142 in costs associated with the Company's investment in the GridSouth RTO as of March 2004. The Company's costs include company labor, the pensions, benefits and taxes associated with such labor, outside services, travel, meals, interest, and other expenses. The Company has also paid amounts to Duke Electric Transmission to true up funding for the RTO. In proposing a five-year amortization, Staff proposes to exclude interest expense from the bills that Staff examined. Interest expense amounted to $527,511 on a total Company basis. The Staff's adjustment amortizes $13,590,631 over five years for an increase to O&M expense of $2,718,126 on a total electric basis. The Company proposed to include the average unamortized investment balance in the RTO in rate base. Staff does not propose to include the unamortized balance in rate base, resulting in a sharing of the GridSouth RTO costs between the ratepayer and stockholders. The retail electric Staff adjustment is $2,546,000. Tr., Vol. 4, Scott at 1302-1303.

The inclusion of GridSouth costs were opposed by several of the parties. Consumer Advocate witness Watkins states flatly that GridSouth costs should not be allowed in this case, because of the reasons expressed in Commission Order No. 2003-38, wherein we rejected inclusion of those costs at the time of issuance of that Order. The stated reasons were that most of the costs had been incurred before the test year, not much detail had been provided by the Company as to the nature of the investment in the project, the Company had not met its burden for cost recovery, and GridSouth was not used and useful during the test year, although it might have been considered property held for future use. Order No. 2003-38 at 16-17. Tr., Vol. 3, Watkins at 973. Navy witness Smith opposes inclusion of the costs on the grounds that they are nonrecurring costs, and the fact that FERC has not approved these costs. Tr., Vol. 4, Smith at 1169-1171. Further, SCEUC witness O'Donnell opposed recovery of GridSouth costs at this time, because of the possibility of the formation of a new RTO type of organization, with SCE&G as a participant. Tr., Vol. 4, O'Donnell at 1237-1238.

The rebuttal testimony of Company witness Julius Wright, however, convinces us that GridSouth costs are properly recoverable in the present Docket. Wright outlines the history of the development of RTOs like GridSouth as a part of a general movement to competition in the electric industry. Wright points to various issued FERC orders. On December 20, 1999, FERC issued its Order No. 2000 which accelerated various initiatives and required utilities regulated by the FERC to file a plan to join or form a regional transmission organization, or RTO, or to provide an explanation as to why this could not be accomplished. Order No. 2000 required this filing to be made within 10 months, and 14 months later, the RTO had to be in full operation. At that time there was simply no question that due to FERC Orders that SCE&G had to begin planning the development of an RTO or begin discussions related to joining an existing RTO. SCE&G had decided that an RTO covering the South Carolina-North Carolina region would best suit SCE&G customers, this Commission, and the Company, in cooperation with Duke Power and Progress Energy Carolinas. This decision and cooperation developed into GridSouth.

Wright noted that a GridSouth RTO filing was submitted to the FERC in late 2000 and SCE&G received conditional approval for the GridSouth RTO in March 2001. Although SCE&G, Duke Power, and Progress Energy Carolinas worked to make GridSouth an operating entity, a change in leadership at FERC changed that agency's regulatory objectives. After this change, the formation of GridSouth was no longer consistent with the FERC's objectives, and on June 13, 2002, the GridSouth RTO project was suspended.

Wright opines that, given this background, there is simply no question that the GridSouth expenditures were a response to regulatory directives, and that the Company had no alternative other than to begin development of an RTO. Wright points out that the GridSouth expenditures should be fully recoverable as reasonable and prudent at this time and in this case for several reasons. First, Wright notes that GridSouth expenditures were made in a prudent effort to comply with regulatory orders. Second, Wright states that the

GridSouth RTO was initially approved by the FERC. Third, GridSouth project's costs were prudently managed as demonstrated by the fact that the Commission Staff audited the resulting expenditures and took no exceptions. Fourth, the abandonment of GridSouth was appropriate in light of dramatic and unanticipated policy changes at the FERC. Lastly, GridSouth assets have now been fully disposed of and there is nothing held for possible future use. Given these facts, Wright argues that it is proper for this Commission to approve the recovery of the GridSouth costs in this proceeding. Tr., Vol. 5, Wright at 1693-1694.

We agree with Wright and believe that the recovery of GridSouth costs is reasonable and appropriate in this proceeding. We disagree that the costs were not used and useful. The expenses were incurred specifically in response to regulatory Orders and directives. Regulated utilities must respond to and remain in compliance with the directives of the regulators with jurisdiction over them, including Federal regulators. Costs incurred to do so are a necessary part of utility operations and are used and useful in providing electric service. We disagree that the expenses should not be recovered because they are primarily related to the wholesale market. The function of GridSouth would have benefited both retail and wholesale customers. Further, the investment in the transmission related functions that GridSouth represents has been treated by the Company in the same way that it has treated other transmission related investments made to serve its system. The GridSouth costs have been allocated to retail and wholesale service in proportion to the use of transmission assets by each of the two classes of service. Given these facts, we agree that it is reasonable to recover the costs for

GridSouth from all ratepayers. There is no evidence that future expenditures will result, since all GridSouth assets have now been disposed of.

We adopt Staff's proposal in this matter. We agree that it is reasonable to allow some sharing of this expense between the ratepayers and the stockholders, and therefore hold that the unamortized balance of the expense shall not be placed in the rate base.

19. CASH WORKING CAPITAL

Staff proposes an adjustment to decrease total Company working capital by $1,098,000 on a total Company basis. On an electric retail basis, this amount is $1,038,000. Tr., Vol. 4, Scott at 1304.

Staff employed the one-eighth cash working capital formula method consisting of one-eighth of O&M expenses on a pure per books basis by recognizing corrections to the books. The one-eighth formula gives the Company 45 days of cash working capital. The 45 days is typical of an electric utility's billing and collection cycle. The formula approach provides a reasonable and unbiased estimate of the Company's cash working capital requirements. It is simpler to use and less costly than the lead lag study proposed by Consumer Advocate witness Watkins. Tr., Vol. 3, Watkins at 977.

The Company proposed calculation of cash working capital utilizing pro forma adjustments. Tr., Vol. 2, Walker at 718. Staff witness Scott opposes this methodology. Staff did not compute cash working capital including pro forma adjustments, because the timing of cash outlays is not as clear cut for pro forma adjustments. Tr., Vol. 4, Scott at 1327. We agree with Staff's reasoning as logical and adopt Staff's positions on cash working capital.

20. INTEREST SYNCHRONIZATION

The Commission Staff proposed an increase to income tax expense by $2,317,000 on a total Company basis, or $2,218,000 as an electric retail amount for interest synchronization. Tr. Vol. 4, Scott at 1304. The Staff limited its interest deduction for income tax purposes to the amount associated with long-term debt based on the rate base, capital structure and embedded cost rates contained in Staff's Exhibit A-5 (Hearing Exhibit No. 33). This adjustment will vary with changes in rate base, capital structure, and/or embedded cost of long-term debt rates. Staff's proposal is reasonable and is hereby adopted.

21. NONALLOWABLES

The Commission Staff is proposing to eliminate O&M expenses considered to be non-allowable for ratemaking purposes. Such expenses include institutional and goodwill advertising, civic club dues, donations, service awards, employee newsletters, one-half of Chamber of Commerce dues and expense, sponsorships, and other miscellaneous items that the Staff does not consider to be necessary for ratemaking purposes. Staff's adjustment lowers O&M expenses by $503,406 on a total Company basis and $487,000 on a retail basis. The adjustment is based on sound regulatory policy. Accordingly, it is approved.

22. CUSTOMER DEPOSITS

The Commission Staff proposes to annualize interest on customer deposits. The Staff used the customer deposits balance of $19,881,605 (retail electric portion) times the Commission-approved interest rate of 3.5%, effective January 1, 2004, to arrive at an annualized interest amount of $695,856. The per books balance of $1,303,130 (retail electric portion) was subtracted from the computed amount to arrive at Staff's adjustment of ($607,274). The Staff decreased interest on customer deposits in cost of service and increased customer deposits by $607,274 in rate base. Tr. Vol. 4, Scott at 1305.

The Staff is also proposing to reduce rate base for the accrued interest on customer deposits of $1,582,143 which is cost-free capital to the Company. The above adjustment to increase rate base by $607,274 is the offset to this adjustment which results in reducing accrued interest to reflect the Commission-approved interest rate of 3.5%. Tr., Vol. 4, Scott at 1305. Staff's proposals are reasonable and are therefore adopted.

Company witness Walker disagreed with Staff methodology, since the reduction was on accrued amounts. Tr., Vol. 2, Walker at 720. Staff witness Scott stated that the adjustment was made since accrued interest on customer deposits is cost-free capital to the Company. The account balance represents amounts owed to customers at the end of the test year. Staff used customer deposits at the end of the test year in the computation of the Company's rate base, and not the amount as of September 30, 2004. Therefore, the Staff's adjustment is consistent with the test year used in this case. Tr., Vol. 4, Scott at 1329. We believe that Staff is correct in this matter and we adopt Staff's position.

23. UNCLAIMED FUNDS

The Commission Staff is proposing to remove unclaimed funds from rate base in the amount of $4,123 on a total Company basis. Unclaimed funds represent amounts owed to customers, unclaimed pay checks, unclaimed deposits, and similar items. The

Staff recommends that such funds be treated as a form of cost free capital to the Company. We agree and approve Staff's adjustment.

24. GENCO CASH WORKING CAPITAL

Staff proposes to remove the cash working capital component associated with GENCO fuel from rate base. Staff found that the bill from Genco to the Company for purchased power contains a cash working capital component. The Staff lowered the cash component of working capital by $7,683,000 on a total Company basis. The retail electric amount is $7,265,000. This adjustment is approved.

25. MOVING EXPENSES

The Staff is proposing to adjust test year moving expenses to reflect a 5-year average amount. Staff averaged moving expenses from 1999 through 2003 for a 5-year average amount of $179,712. Staff subtracted this amount from the test year amount of $443,855 for an adjustment of $264,143 on a total Company basis. The retail electric amount is $253,000. Tr., Vol. 4, Scott at 1306. This adjustment is approved.

26. OFFICER'S BONUSES AND SALARY INCREASES

The Commission Staff proposes to remove officer's bonuses and salary increases from the test year expenses. Consumer Advocate witness Watkins proffers a similar theory, with different amounts. Tr., Vol. 3, Watkins at 964. Staff removed $6,549,083 in bonuses and $221,547 in salary increases for a total Company amount of $6,770,630. Staff also removed $10,970 for FICA taxes. The retail electric amounts are $6,503,000 for bonuses and salary increases and $11,000 for FICA taxes. Staff states its reasons for these adjustments, among other things, as follows: Officer incentive compensation payments are possibly non-recurring items, depending on whether or not certain goals are met by the Company and/or the recipient; the adjustment prevents utilities from providing officers with large wage increases or incentive compensation payments to help justify rate relief or prevent rate reductions; the adjustment promotes a sharing of test year salaries and wages between the ratepayer and shareholder. Tr., Vol. 4, Scott at 1307.

We would note that the Company did not pay out officer incentive compensation payments in the year 2002, which demonstrates the possibility of such payments being non-recurring items. We have treated these payments in different ways over the years. We think the better procedure is to approve the proposed Staff adjustment, and we do, due to the possibly non-recurring nature of the bonus payments, and the very reasonable policy of promoting a sharing of test year salaries and wages between the ratepayer and the shareholder. We disagree with the position of the Company that these monies should be recovered in full as reasonable and prudent costs of providing utility services. Tr. Vol. 2, Walker at 721.

27. LITIGATION EXPENSES AND LEGAL FEES

The Staff proposes to remove accrued litigation expenses that are not known and measurable of $1,023,675 for total electric and $983,000 for retail operations. Further, the Staff is proposing an adjustment to remove legal fees of $87,884 associated with the over-billing of franchise fees for certain Company customers. This overbilling was a Company error. The retail amount was $85,000. We adopt both adjustments as being reasonable.

28. INCOME TAXES

The Commission Staff is proposing an adjustment to correct the per book income taxes for an error made in the filing. Total taxes per books were $106,083,571 less the per filing income tax amount of $101,707,000, for an adjustment of $4,376,571. The Utilities Department provided the retail electric amount of $4,193,000. We agree that the error should be corrected, and therefore approve the proposed Staff adjustment. Tr., Vol. 4, Scott at 1309.

29. MISCELLANEOUS ADJUSTMENTS

All other adjustments proposed by the Commission Staff and not discussed hereinabove are hereby adopted, for the reasons cited in Commission Staff testimony. We adopt the Commission Staff's Audit Exhibit A (a part of Hearing Exhibit No. 33) to show the proper calculation of revenue, expenses, and rate base.

III.
EVIDENCE AND CONCLUSIONS REGARDING COST OF CAPITAL

1. COST OF EQUITY

(a) LEGAL STANDARDS

In setting rates, the Commission must determine a fair rate of return that the utility should be allowed the opportunity to earn after recovery of the expenses of utility operations. The legal standards applicable to this determination are set forth in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 602-03 (1944) and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692-73 (1923). These standards were adopted by the South

Carolina Supreme Court in *Southern Bell Telephone and Telegraph Co. v. South Carolina Public Service Commission*, 244 S.E. 2d. 278, 281 (S.C. 1978).

Specifically, *Bluefield* holds that:

> What annual rate will constitute just compensation depends upon many circumstances, and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting the opportunities for investment, the money market and business conditions generally.

Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. at 692-73, as quoted in *Southern Bell Telephone and Telegraph co. v. South Carolina Public Service Commission*, 244 S.E. 2d. at 281. In addition, these cases establish that the process of determining rates of return requires the exercise of informed judgment by the Commission. As the South Carolina Supreme Court has held, quoting *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. at 602-03:

> the Commission was not bound to the use of any single formula or combination of formulae in determining rates. Its ratemaking function, moreover, involves the making of 'pragmatic adjustments'. . . . Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. . . . The ratemaking process under the Act, i.e., the fixing of 'just and reasonable' rates, involves the balancing of the investor and the consumer interests.

Southern Bell Telephone and Telegraph Co. v. South Carolina Public Service Commission, 244 S.E. 2d. at 281. This is in keeping with the general rule that "[r]atemaking is not an exact science, but a legislative function involving many questions of judgment and discretion." *Parker v. South Carolina Pub. Service Commission*, 313 S.E.2d 290, 291 (S.C. 1984).

These principles have been employed by the Commission and the Courts of this State consistently since their adoption in 1978. They continue to provide the appropriate standards to guide the Commission's determination of rates of return in proceedings such as this one. From these authorities, the Commission derives the following specific points to guide its evaluation of the evidence in this case:

1) The rate of return should be sufficient to allow SCE&G the opportunity to earn a return equal to firms facing similar risks;
2) The rate of return should be adequate to assure investors of the financial soundness of the utility and to support the utility's credit and ability to raise capital needed for on-going utility operations at reasonable cost;
3) The rate of return should be determined with due regard for the present business and capital market conditions facing the utility;
4) The rate of return is not formula-based but requires an informed expert judgment by the Commission balancing the interests of shareholders and customers.

Finally, the Commission notes that "[t]he determination of a fair rate of return must be documented fully in its findings of fact and based exclusively on reliable, probative, and substantial evidence on the whole record." *Porter v. South Carolina Public Service Commission,* 504 S.E.2d 320, 323 (S.C. 1998) citing *S.C. Code Ann*. § 58-5-240 (Supp. 2002); accord S.C. Ann. § 58-27-870(G) (Supp. 2002).

(b) OVERVIEW

In all, four witnesses testified as to the appropriate cost of capital for SCE&G based on the use of financial models. Those witnesses were

- Burton G. Malkiel, Ph.D., the Chemical Bank Chairman's Professor of Economics at Princeton University who testified on behalf of SCE&G. Dr. Malkiel is former Chairman of the Economics Department of Princeton, former Dean of the Yale Business School, and a former member of the President's Council of Economic Advisors. He is a member of the Board of Directors and Chairman of the Investment Committee of Prudential Securities Company and is a Member of the Board of Directors of Vanguard Group of Investment Companies. Dr. Malkiel has published extensively on finance issues both in the academic and popular press;
- Glenn A. Watkins, Vice-President and Senior Economist, with Technical Associates, Inc. who testified on behalf of the Consumer Advocate;
- Kevin W. O'Donnell, President of Nova Energy Consultants, Inc., who testified on behalf of the South Carolina Energy Users Committee; and
- Labros E. Pilalis, Research Analyst, Rhoads & Sinon Group, LLC

In addition, Thomas R. Osborne, Managing Director in the Global Power Group of UBS Warburg, LLC's Investment Banking Department, testified on behalf of SCE&G concerning conditions in national capital markets and the group of comparable companies he selected and provided to Dr. Malkiel as an input to Dr. Malkiel's calculations. Also, Kevin Marsh, SCE&G's Senior Vice President and Chief Financial Officer, testified on the present business and market conditions that the Company is facing and concerning the flotation costs the Company has incurred in issuing new capital. Further, Julie M. Cannell, President of J.M. Cannell, Inc. testified on investors' perceptions related to the present proceeding, how investors evaluate investments in utility companies, and the appropriate rate of return on equity for SCE&G from an investor's perspective. Summary results of the financial analyses conducted by the four witnesses who offered opinions regarding SCE&G's equity capital are as follows:

RESULTS	WITNESS			
	Dr. Malkiel	Mr. Watkins	Mr. O'Donnell	Mr. Pilalis
DCF	10.5-12.45%	8.7%-9.4% 8.6%-9.2%	8.5%-10%	9.21%
CAPM	Not Used	9.9-10.2%	Not Used	10.55%
Comp. Earnings	Not used	11.0%	Not used	Not used
Flotation Adjustment	4.25%	Not Included	Not Included	Not Included
Recommendation	11.5%	9.1-10.1%	10%	9.88%

(c) DISCUSSION OF TESTIMONY AND CONCLUSION

ON RATE OF RETURN

Labros Pilalis, testifying for the Commission Staff, employed the Discounted Cash Flow (DCF) and the Capital Asset Pricing Model (CAPM) methods to estimate the cost of common equity capital for SCE&G. Since SCE&G does not have common equity stock securities that are publicly traded, Pilalis relied on relevant market-based information of the publicly traded common stock securities of SCANA corporation and for the proxy group of holding companies with regulated electric and gas public utility subsidiaries that were utilized in Dr. Burton Malkiel's testimony.

With regard to the DCF method, Pilalis averaged the DCF cost of common equity estimates of the six enterprises that are members of the proxy group of companies. This average cost of common equity rate is 9.36%. He then averaged this figure with SCANA's stand-alone DCF cost of common equity capital of 9.07%. Accordingly, Pilalis' adopted and recommended DCF-based cost rate for the common equity capital of SCE&G is 9.21%. Tr., Vol. 5, Pilalis at 1484.

Pilalis also employed the CAPM method. He averaged the CAPM cost of common equity estimates of the six (6) enterprises that are members of the proxy group of companies. This average cost of common equity rate is 10.74%. Pilalis then averaged this figure with SCANA's stand-alone CAPM cost of common equity capital of 10.35%. Pilalis' adopted and recommended CAPM-based cost rate for the common equity capital of SCE&G is 10.55%. Id. at 1489.

By giving equal weight to his DCF and CAPM cost of common equity estimates of 9.21% and 10.74% respectively, Pilalis' overall recommendation for the rate of return on the common equity capital of SCE&G is 9.88%. Id. This equates to an overall rate of return of 8.22%. Tr., Vol. 4, Scott at 1310.

Pilalis does not include an adjustment for flotation costs. Although Pilalis is not opposed to the rate recovery of SCE&G's reasonable flotation costs, he is of the opinion that this rate recovery should take place as the normal rate recovery of an expense item and not as a flotation cost adjustment to the authorized rate of return. Tr., Vol. 5, Pilalis at 1489-1490.

Pilalis' proposed rate of return is reasonable, given all the data presented to this Commission. It lies within the ranges of rates of return proposed by South Carolina Energy Users witness O'Donnell and Consumer Advocate witness Watkins. The difference between Mr. Pilalis DCF rate of return recommendation and that of Dr. Malkiel appear to be due to a difference in the size of the dividend growth rates used by the two witnesses in their respective DCF calculations. Dr. Malkiel's growth rates appear to be higher than those used by Mr. Pilalis. Id. at 1483. We hereby hold that Mr. Pilalis' dividend growth rates are from sources that are more verifiable than those employed by Dr. Malkiel. The sources employed by Dr. Malkiel were not readily available. Id. at 1482. Mr. Pilalis DCF result of 9.21% was lower than that of Dr. Malkiel at 10.5-12.45% Tr., Vol. 2, Malkiel at 471.

In any event, we adopt Mr. Pilalis' estimate of the cost of equity capital of 9.88%.

IV.

EVIDENCE AND CONCLUSIONS REGARDING

COST OF SERVICE AND RATE DESIGN

The cost of service studies provided by the Company provide for the allocation of the Company's rate base, revenues, and expenses to total Company and South Carolina retail. These Studies also separate these items by class of service within the South Carolina retail jurisdiction. Development of the Cost of Service Studies entails three major components: functionalization, classification, and allocation. First, the rate base, revenues, and expenses were functionalized into appropriate categories relating to production, transmission, and distribution. These costs were then classified according to the characteristics of the type of service to which they correspond, namely the customer, demand and energy components. These cost components were then allocated to the individual classes of service based upon the responsibility of each class for the customer, demand and energy expense. Additionally, costs that were identified as being attributable to a specific jurisdiction or class were directly assigned to that category. The Commission Staff concluded from its review that the methodology applied in constructing these cost studies continues to provide reasonable apportionment and allocation of the Company's revenues, operating expenses and rate base. Hearing Exhibit 36, Section A. Based on Staff's conclusions, we agree.

The Staff has verified the percent increase requested by SCE&G for each class by rate schedule by a computation of the presently approved rates and proposed rates applied to the April 1, 2003 through March 31, 2004 test period data. This was combined with a review of the Company's rates, tariffs, and General Terms and Conditions. These figures are based on test year active customers' billing determinants applied to the presently approved rates and the proposed rates. The Company's retail rate schedules are grouped into three principal categories: Residential, General and Lighting. The total requested increase to the Residential Class is 8.81%; the proposed increase to the Small General Service Class is 3.31%, with a 5.01% increase proposed for the Medium General Service Class and 2.01% increase proposed for the Large General Service Customer Class. The total requested increase for the Lighting Class is 6.25%. The Company filed its application with the Commission based on a proposed fuel factor of $.01764 per KWH requesting authority to adjust and increase its retail electric rates and charges. Hearing

Exhibit 35, Section C. See also the testimony of Staff witness Coates. Tr., Vol. 4, Coates at 1362. We concur with the Staff's calculation of the requested percentage increases.

The Company also proposes modification to its monthly basic facilities charge in its residential rates, i.e. an increase of $1.00 in Rates 1, 2, 6, and 8. The proposed increase in Rate 5 goes from $11.25 to $12.70. The Company also proposes modification to its monthly basic facilities charge in its Small General Services Class ranging from $.025 to $2.00; in its Medium General Service Class, the Company proposes a $20.00 increase; and in its Large General Service Class, a $100.00 increase. Further, the Company proposes changes to its General Terms and Conditions for electric service increasing the Reconnection Fee from $15.00 to $25.00. Id. We concur with Staff's summary of the proposed increases in the various monthly basic facilities charges and the statement with regard to the proposed increase in the Reconnection Fee.

With regard to the Reconnection Fee, the Commission Staff has analyzed the cost and data provided by the Company, and has concluded that the expense incurred by the Company to perform this activity is in excess of the amount requested, and therefore supports the increased level. Tr., Vol. 4, Watts at 1376. The most recent adjustment to the reconnection fee occurred in 1993. A weighted calculation of the actual expense results in a calculation of the cost at $30.18. Id. We approve the requested increase in this fee. However, we reject the Company's proposal to impose the reconnection charge if Company personnel make the trip to reconnect but are thwarted as the result of actions taken by the customer. This proposal would have modified the Company's General Terms and Conditions, Section III, Conditions of Service, Subsection K, Reconnection

Charge. The Company provided no specific information to ascertain the frequency and corresponding severity or financial impact of the proposal. Id. at 1377.

The Company proposes an addition of Section IV (D) 5 to its General Terms and Conditions, which would allow the Company to collect a deposit if a nonresidential customer's credit standing has deteriorated to a level of insecurity. The Company proposes to apply this to nonresidential customers, excluding sole proprietorships, where at least three of the prior twelve monthly billings equal or exceed $25,000. In addition, the Company proposes three specific financial alert conditions for which, if any one or more occur, the application of a deposit for that customer would be prompted. Deposit options may include cash, surety bond, letters of credit or guarantors. The Company further states that it will give the effected customer 30 days notice prior to the due date of the deposit and would also notify the Office of Regulatory Staff at that time. The Company's reasoning is that this will provide it with the opportunity to reduce and in some circumstances eliminate uncollectibles and resulting write-offs which become the burden of the remainder of the ratepayers. We would note that the Commission recently approved a similar proposal for Duke Power on a one-year experimental basis pursuant to Order No. 2004-417. Approval would also require a waiver of Commission Regulation 103-331(A) which establishes the criteria for a customer deposit.

Because this Commission has approved the methodology on a one-year experimental basis for Duke Power, we approve SCE&G's proposal on a similar basis. We also waive Commission Regulation 103-331(A) for this particular purpose. SCE&G

shall report back to us in one year as to its use of this procedure, and shall include any difficulties that may have arisen with its customers over application of the methodology.

We would also note that the Company is proposing a change to its interruptible rider for Rates 23 and 24. The Company is requesting to cap the rider for all current customers at their existing contract levels and close that rider to new accounts. Further, the Company proposes a new interruptible rider to Rates 23 and 24 to allow interruption for economic reasons as well as capacity shortages and system emergencies. SCE&G also proposes in this new rider to allow the customer to buy through any economic interruption at a quoted market price at that time. The proposed rider will be explicit that an interruption can be for economic reasons as well as capacity and system emergencies. We believe that the proposal makes reasonable changes to the interruptible rider for Rates 23 and 24, and therefore we approve the proposed changes.

Further, Columbia Energy witness David Dismukes proposes an RFP (Request for Proposal) process that would, among other things, "…ensure, up front, any costs incurred by a utility to serve its customers have been tested by the market." Tr., Vol. 3, Dismukes at 1087. Dismukes goes on to state how the utility would submit a need determination for additional sources of power to the regulator, along with a proposed methodology for meeting that need. A solicitation or RFP is then developed. Id. At this time, we do not believe that the development of such a process is needed. Indeed, this Commission has already addressed this idea in principle in its Integrated Resource Planning (IRP) Orders. In Order No. 91-1002, we first outlined comprehensive requirements for the development and composition of an IRP filing for electric utilities. The IRP requirements already established obviate the need for an additional process. We specifically noted in Order No. 91-1002, Appendix A, page 9, Item 16 that "Utilities must adequately consider all cost effective third-party power purchases including firm, unit, etc., consistent with the IRP objective statement. This involves consideration of both interconnected and non-interconnected third-party purchases. The utility will describe any consideration of joint planning with other utilities. The utility will identify all third party power purchase agreements."

This item is just one of the numerous and extensive requirements for Integrated Resource Planning published in Order No. 91-1002. We have subsequently updated our IRP requirements through Order Nos. 93-845 and 98-502. Essentially, the IRP process already established by this Commission eliminates the need for the process proposed by Dr. Dismukes.

V.

CONCLUSION

Once again, it must be emphasized that the material included herein should be employed by the Commission only in such a case as the Commission rejects the Stipulation reached among the various parties. Whereas, the Staff has included herein language for a proposed order including Staff positions originally proposed in Staff's original testimony, the Staff continues to endorse the Stipulation reached between SCE&G, the Staff, the South Carolina Energy Users Committee, SMI Steel, and Wal-Mart as containing the most appropriate holdings for the issues in this very complex case. However, should the Commission, for whatever reason, ultimately reject the Stipulation, the Commission Staff has furnished herein language which would be useful, should the Commission wish to adopt Staff positions on the various issues within this case.

Respectfully submitted,

F. David Butler
General Counsel
December 1, 2004

TAB C

STATE OF SOUTH CAROLINA

BEFORE THE PUBLIC SERVICE COMMISSION

DOCKET NO. 2004-178-E

IN THE MATTER OF:	)	
	)	
	)	
Application of South Carolina Electric	)	**APPENDIX TO PROPOSED ORDER**
& Gas Company for Adjustments in the	)	
Company's Electric Rate Schedules and	)	
Tariffs	)	

POST HEARING PROCEDURE (ORDER)

In the interest of judicial economy and for the ease of the Commission and other parties, the South Carolina Energy Users Committee (SCEUC) has joined with South Carolina Electric & Gas Company (SCE&G) and the Staff of the South Carolina Public Service Commission (Staff) in a proposed order resolving all issues in the within rate case consistent with the parties' stipulation and settlement agreements. To the extent the proposed order conforms with the terms and conditions of the parties' stipulation and settlement agreements, SCEUC would urge its approval. SCEUC does not adopt or urge approval of any provisions of the order proposed by SCE&G that do not conform to the terms and conditions of the parties' stipulation and settlement agreements or that conflict with the terms of the parties' stipulation and settlement agreements (or which conflict with any position adopted by SCEUC outside the terms of the parties' agreement). By joining in the order proposed for the limited purposes outlined herein, SCEUC does not waive any argument or position it may otherwise have in the instant proceeding or any proceeding arising from the instant proceeding.

In the event the South Carolina Public Service Commission (Commission) declines to accept the parties' stipulation and settlement agreements as its order, SCEUC would submit the following as dispositive of the issues it raised in the instant proceeding.

TESTIMONY OF WITNESS KEVIN W. O'DONNELL

A. Witness Qualifications. Kevin W. O'Donnell received a B.S. Degree in Civil Engineering – Construction Option from North Carolina State University in 1982 and a Masters Degree in Business Administration and Finance from Florida State University in August of 1984. In September of 1984, O'Donnell joined the public staff of the North Carolina Utilities Commission where he worked as a public utilities engineer and public utility financial analyst. Beginning in 1991, O'Donnell worked as a financial analyst and rate analyst, and at the time of the hearing herein, was so employed by Nova Energy Consultants, Inc. O'Donnell is a chartered financial analyst (CFA) and member of the Association of Management and Research. O'Donnell served as a senior financial analyst with MAKROD Investment Associates, a money management firm based in Verona, New Jersey. O'Donnell has appeared and testified before the North Carolina Utilities Commission and the South Carolina Public Service Commission in various rate matters. O'Donnell has also testified before Congress. In his practice, O'Donnell serves as an electrical consultant for several municipalities in North Carolina which purchase their power on the open wholesale market and has worked with North Carolina and South Carolina municipalities before the Federal Energy Regulatory Commission. Last, O'Donnell has published articles for *Public Utilities Fortnightly* and the *Energy Buyers Guide* (Tr.at 1221, L.12 -1224, L.9).

B. South Carolina Manufacturing Economic Climate. Today's tough economic climate requires manufacturers to keep all costs including electric power costs as low as possible in order to keep their plants open and to keep South Carolinians employed. As of the filing of SCE&G's rate application, South Carolina manufacturers employed 270,600 people, a number down from 380,000 manufacturing employees in South Carolina in 1995. South Carolina manufacturers not only provide gainful employment for their employees, but also impact the local economy. Once a plant opens, contractors and suppliers open nearby. Service companies benefit from increased manufacturing activity and employment. In addition to employment benefits, manufacturers, suppliers and service companies contribute substantially to the tax base, as well as contributing tax payments. In addition to the personal loss associated with 100,000 job lay offs by manufacturers in the last decade, the economy suffered lost tax revenues, both corporate and personal. Accordingly, any rate increase would prove burdensome to large manufactures and should be minimized in the interest of economic development. (Tr. at P. 1254, L. 17-P. 1255, L.20)

C. Cost of Service & Rate Design. Relying upon the utility's cost of service study, the witness O'Donnell testified that rate realignment was needed in this case. O'Donnell testified that under current rate design, manufacturers were paying more than their fair share of SCE&G's system-wide cost and that by accepting SCE&G's rate design, the Commission could move to correct this inequity. In designing its proposed rates, SCE&G decided to follow a long standing Commission practice of allocating its generation investment in the way each customer class uses electricity in the summer peak period. The summer peak cost of service method accurately reflects the impact of each customer class on the demands of SCE&G's system. The peak usages on the system occur in the summer months when the residential customers are running air conditioners and other appliances. Accordingly, SCE&G must build sufficient generating capacity to meet the demand on its system by residential customers. Manufacturers on the other hand place a steady demand on the utility's system throughout the year. By designing rates according to the summer peak cost of service methodology used by SCE&G, rates are designed to reflect the electricity use of each customer class during the peak summer months and more accurately conform to the cost of service of each of the customer classes. The cost of service study shows that large manufacturers are paying more than their fair share of the cost of service. SCE&G's rate design reduces the cost to manufacturers and, while not entirely cost based, is more equitable than current rates. Accordingly, the utility's rate design should be adopted in this proceeding by the Commission. If the Commission does not accept the parties' settlement, rates should be adjusted proportionally to SCE&G's rate design proposal (Tr. at P. 259, L. 25-P. 1262, L10;P. 1264, Ls. 19-21).

D. Rate of Return. Employing the discounted cash flow (DCF) model, O'Donnell determined that an appropriate rate of return for SCE&G in this application is 10%. O'Donnell testified that the DCF model is the most appropriate method of establishing the rate of return in such cases and that he has used the model extensively in analyzing rate requests in his presentations to regulatory bodies. O'Donnell analyzed the rate request by employing the use of his own comparable companies, as opposed to the comparable group employed by other witnesses. Employing his own discreet group of comparable companies, O'Donnell found a return of 10% to be appropriate in this case, a return identical to that recommended by Malkiel (without floatation costs) (Tr. at P. 1258, L 23-P. 1259, L. 24). Although witnesses for the Consumer Advocate and Staff employed the discounted cash flow model to arrive at recommended returns of less than 10%, the return granted by this Commission certainly should not exceed 10%. According to O'Donnell, a 10% rate of return would be deemed fair and appropriate by money managers and professional investors. Given today's investment climate, an overall rate of return of 10% by SCE&G would send a favorable signal to the financial markets (Tr. at P 1235, Ls. 13-18).

In spite of the fact that both O'Donnell and Malkiel employ the DCF model to reach the identical conclusion, i.e. that a 10% rate of return is appropriate for SCE&G, the witness Osborne challenges O'Donnell's proxy group. Osborne seems to reason that because O'Donnell's proxy group is flawed, his DCF conclusion is likewise flawed; therefore, Malkiel's conclusion that the utility was entitled to a 10% rate of return was more correct. This argument defies logic. Either Malkiel's and O'Donnell's conclusions are both correct or their conclusions are both wrong. If both are wrong, the rate of return should be set as that recommended by witnesses for the Consumer Advocate and the Staff. One would doubt that SCE&G intends to undercut the credibility of its witness Malkiel in this manner. However, SCEUC is firm in its resolve that a 10% return on equity is most appropriate.

E. GridSouth Expense. Citing concerns of limited transmission capacity, O'Donnell testified that SCE&G will be forced by circumstances to involve itself again with a regional transmission organization (or RTO) in the future (Tr. at P. 1238, Ls. 5-30). O'Donnell testified that the GridSouth RTO as created by SCE&G, Duke Energy and Progress Energy was insufficient to further the development of a wholesale power market in their combined service territories (Tr. at P. 1237, Ls. 15-21). Moreover, GridSouth was never used and useful for the betterment of South Carolina and its citizens. Accordingly, O'Donnell testified SCE&G's request to recover its GridSouth expenses should be denied (Tr. at P. 1238, Ls. 1-3).

F. Requested Change in Credit Standards (Security Deposits). SCE&G failed to establish the necessity to collect security deposits from large industrial customers which the utility deemed to be a credit risk (Tr. at P. 1239, Ls. 5-6). Moreover, according to O'Donnell, SCE&G will not be prejudiced by the Commission's rejecting its application to collect security deposits from industrial customers which it deems to be a credit risk because traditional regulatory ratemaking allows the utility to recover uncollectible expense through a slight increase in existing rates. Such a deposit would be redundant and is unnecessary (Tr. at P. 1239, Ls. 15-17).

G. Interruptible Riders. The utility proposed to cap the existing interruptible rider to rates 23 and 24 for current customers at their existing contract levels and to close the rider to new accounts. The utility proposed a new interruptible rider that would allow the company to interrupt for economic and capacity shortage reasons. Customers accepting the new tariff would be permitted to buy through any economic interruption at the market price to be dictated by the utility. The proposal to cap the existing rider and to establish an interruptible rider permitting economic curtailment should be denied. O'Donnell testified that the interruptible rider benefits the large industrial customer by permitting it to reduce its electricity costs. In exchange for permitting the utility to interrupt its service when the electricity is needed to meet its peak demands, the interruptible customer is given a credit towards its utility costs, thereby reducing its electricity cost (Tr. at P. 1241, L. 19 – P. 1242, L. 9).

Capping the existing rider to existing customers would deprive large manufacturers of an important opportunity to minimize their electricity costs. The new rider permitting economic curtailment is objectionable, because it deprives the interruptible manufacturer of the ability to plan production. Large liquid electricity markets provide for price transparency. Southeastern markets are neither large nor liquid. In other words, there is no market exchange by which an industrial customer can determine at what rate electricity is being sold from any given utility to any of its customers. Without such transparency, manufacturers cannot plan for outages which occur when SCE&G interrupts their service for economic reasons. Manufacturers would have no way to determine whether the price at which the utility offered to permit it to buy through was reasonable in light of the prevailing market conditions. It would be impossible for this manufacturer to determine whether it was feasible or prudent to buy through the economic curtailment and continue to operate its manufacturing process at the increased rate. Neither closing the existing rider, as proposed, nor establishing the proposed rider permitting economic curtailment is in the interest of the customers of SCE&G. (Tr. at P. 1242, L 11 – P. 1243, L 7; P. 1263, Ls. 18-25; P. 1264, L 23-P. 1266, L. 62)

CONCLUSION

Circumstances are little changed from the economic climate of 2002, at which time this Commission recognized in the most recent rate case for Piedmont Natural Gas:

1. The records show that industrial customers were subsidizing residential and commercial customers. Reduction or elimination to this subsidization was viewed favorably.

2. Appropriate industrial rate designs could help the State of South Carolina retain existing industry and perhaps attract new industry. The Commission found that was particularly important given the significant loss of manufacturing jobs in the State of South Carolina in recent years. The Commission also observed that the loss in manufacturing jobs had a profound affect on personal income, personal income tax revenues, and unemployment payments and other government-related costs.

3. The commission also observed the appropriate rate design principles help respond to the price sensitive industrial market and better allow natural gas companies to compete with alternative fuels for these price sensitive companies. Order No. 2002-761 in Docket No. 2002-63-G

Similarly the Commission should act here to foster economic development. Return on equity should not exceed 10%. Expenses such as those for GridSouth which never proved used and useful should be rejected. Limiting opportunities for manufacturers by closing the existing interruptible rider and permitting SCE&G in its discretion to collect security deposits are economically burdensome. Above all, rates set by this Commission should be based according to SCE&G's rate design proposal.

Respectfully submitted,

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December 1, 2004

BEFORE THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA DOCKET NO. 2004-178-E

IN RE:	Application of South Carolina Electric & Gas Company for Adjustments in the Company's Electric Rate Schedules and Tariffs	))))	**CERTIFICATE OF SERVICE**

I, Amelia McKie, the undersigned employee of Haynsworth Sinkler Boyd, P.A., hereby certify that I have this 1st day of December, caused a copy of the *Post Hearing Brief of South Carolina Electric & Gas Company in the Form of a Proposed Order,* which has been filed on behalf of South Carolina Electric & Gas Company, in the above-referenced docket, to be served on all parties of record whose names appear below via U. S. Mail (unless otherwise indicated):

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